(1)

FILED
SEP 17 1941
CHARLES ELMORE CROPLEY
CLERK

314 U.S. 633
MCL-MLT
314-670

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

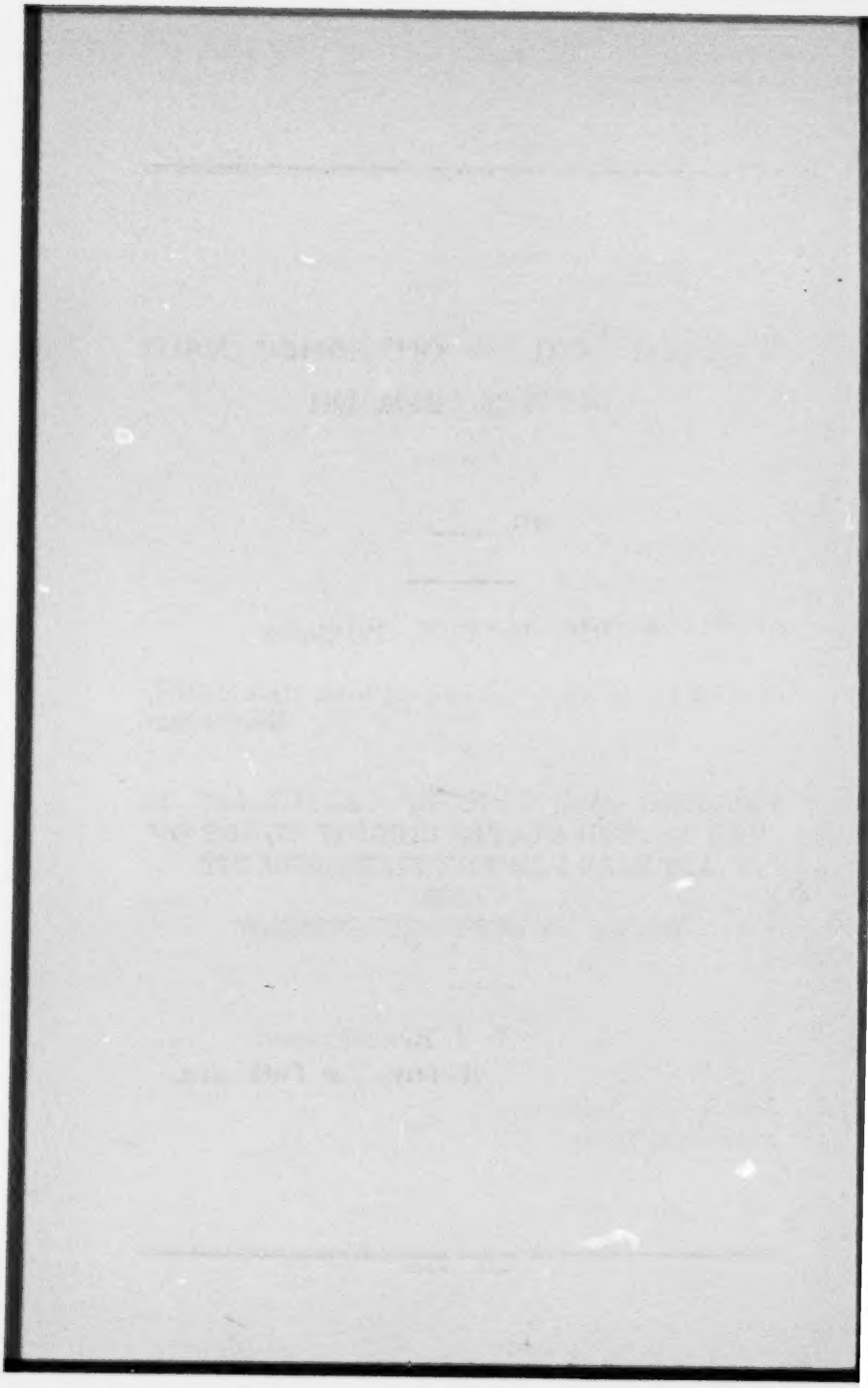
NO. 624

MARRS McLEAN, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

L. J. BENCKENSTEIN,
Attorney for Petitioner.

San Jacinto Building,
Beaumont, Texas.



SUBJECT INDEX

	Page
Petition for Writ of Certiorari:	
A. Summary Statement of the Matter Involved	2- 8
1. Preliminary	2- 3
2. Questions Presented	3
3. Statement of the Case	3- 7
4. Specifications of Error to Be Urged	7- 8
B. Reasons for Granting the Writ	8-18
Conclusion	18
Brief in Support of Petition:	
I. Opinion Below	21
II. Jurisdiction	22
III. Statement of the Case	22
IV. Statutes Involved	23
V. Specifications of Error	23-24
VI. Argument	24-26
1. The Word "Sale" Should Be Given Its Ordinary Meaning	25-26
2. The Transaction Was Clearly a Sale	26-32
3. The Opinion Below Is an Erroneous Interpretation and Improper Application of the Decisions of This Court	32-36
Conclusion	36
Appendix A—Statutes Involved	37-39
Appendix B—G. C. M. 22730 (1941-26-10,755)	40-63

CITATIONS

	Page
Anderson v. Helvering, 310 U. S. 404	10, 12, 14, 15, 33, 35
Blankenship v. U. S., 95 F. (2d) 507	10
Bonwit-Teller & Co. v. U. S., 258, 263	12
Burnet v. Harmel, 287 U. S. 103	12, 25
Commissioner of Int. Rev. v. Fleming, 82 F. (2d) 324	15, 26

32552

Page

Commissioner of Int. Rev. v. Roeser & Pendleton, Inc., 118 F. (2d) 462 15

First Seattle Dexter Horton Nat'l Bank et al. v. Commr., 77 Fed. (2d) 45 ..... 16, 32
Five Per Cent Cases, 110 U. S. 471 26
Fowler v. U. S., 11 F. (2d) 895 25

Helvering v. Tex-Penn Oil Co. et al., 300 U. S. 48 17
Helvering v. Wm. Flaccus Oak Leather Co. (U. S. Sup. Ct. No. 627), Apr. 28, 1941 25
Helvering v. Elbe Land Development Co., 303 U. S. 372 ..... 10, 12, 13, 33
Herring v. Comm. Int. Rev., 293 U. S. 322 10

Jefferson Coal & Gas Company v. Commr., 52 F. (2d) 120 ..... 17, 32

Lynch v. Alsworth-Stephens Co., 267 U. S. 364, 369 26

Palmer v. Bender, 287 U. S. 551 ..... 12, 15, 33, 35

Spalding v. U. S. 97 Fed. (2d) 701 10

Thomas v. Perkins, 301 U. S. 655 ..... 11, 12, 13, 33

U. S. Phellis, 257 U. S. 156, 168 17

Williamson v. Berry, 8 Howard, 495, 543 26

STATUTES

Page

Rev. Act of 1928 ..... 2, 3, 6, 7, 8, 9, 13, 18, 23, 24, 32
Rev. Act of 1932 ..... 2, 3, 6, 7, 8, 9, 13, 18, 23, 24, 32
Rev. Act of 1934 ..... 2, 3, 6, 7, 8, 9, 13, 18, 23, 24, 32
Judicial Code, Sec. 240(a) (43 Stat. 938) 22
I. R. C., Sec. 117 ..... 2, 12
I. R. C., Sec. 105 2

TEXTS

Page

G. C. M. 22,730 (1941-26-10,755) 9, 25
1 Paul & Mertens, p. 22, Sec. 2.05 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

NO.....

MARRS McLEAN, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

To the Honorable Harlan F. Stone, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

Marrs McLean, an individual, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered in the above cause on June 20, 1941, affirming a decision of the Board of Tax Appeals.

Your petitioner respectfully shows:

A.

Summary Statement of the Matter Involved.

1. Preliminary.

In 1931 petitioner transferred and assigned to Yount-Lee Oil Company certain oil leases, the leasehold estates created thereby, and the physical properties and equipment thereon, less and except a royalty of twenty-five per centum of the oil produced and saved therefrom, out of which all outstanding royalties were to be paid, including that due the lessors, for a consideration of Five Hundred Thousand Dollars cash, and Two Million Dollars to be paid out of one-eighth of the gross oil to be produced.

In filing his income tax returns for the years 1931 to 1935, inclusive, the taxpayer reported the cash payment and the amounts collected on the Two Million Dollar payment, as capital gains as provided for in Sections 101 of the Revenue Acts of 1928 and 1932, and Section 117 of the Revenue Act of 1934[1]. (R. 223.)

Respondent determined that the reservation and exception of a royalty in excess of that reserved by the lessors, and out of which petitioner assumed to pay all outstanding royalties, *prevented* the transaction from being a sale, either within the purview of the capital gains provisions of the Revenue Acts of 1928, 1932 and 1934, or "Prospectors' Relief" provision (Section 102)[2] of the Revenue Acts of

---

1I. R. C., Sec. 117.

2I. R. C., Sec. 105.

1928 and 1932. Based on that premise he determined that both the cash and the payments received on account of the Two Million Dollars constituted ordinary income, and are taxable as such. Deficiencies resulted. The Board of Tax Appeals sustained the determination, and the court below affirmed the Board.

2. Questions Presented.

The principal questions are:

(1) Whether or not the transaction constituted a sale within the meaning of the capital gains provisions of the Revenue Acts of 1928, 1932 and 1934.

(2) Whether or not the transaction constituted a sale within the meaning of Sections 102 of the Revenue Acts of 1928 and 1932.

3. Statement of the Case.

In 1919 the petitioner leased from Cade and others, lands situated at High Island in Galveston County, Texas, for the exploration and development of oil, gas and other minerals. A royalty of twelve and one-half per centum of the oil produced and saved upon the lands was reserved to the owners.

Before March 18, 1931, petitioner succeeded in discovering oil in commercial quantities upon the leased premises. (R. 215.) On that date he entered into a written agreement with the Yount-Lee Oil Company. (R. 271-277.) Under the terms thereof, for a consideration of Five Hundred Thousand Dollars cash and "Two Million Dollars to be paid

out of one-eighth of the gross oil produced and saved from the lands * * * if, as and when produced and saved, and only in that event," he "granted, sold, conveyed, transferred and assigned" to that company the "leases * * * leasehold estates created thereby" and "all physical properties and equipment thereon," less and except a "royalty of twenty-five per centum of the oil produced and saved," out of which all outstanding royalties, including that due the lessors, were to be paid.

The transfer of seventy-five per cent of the oil included one hundred per cent of the ownership and control of the working or operating interest. There were no restrictions or limitations as to use, no obligations with respect to development and producing operations, and no provision for reversion. (R. 271-277.)

On the date of the above transaction McLean was the owner of the leases, and in addition, owned a one-fifth of the one-eighth royalty reserved by the original lessors. (R. 217.)

The Yount-Lee Oil Company drilled numerous wells upon the leases, which produced and, at the commencement of these proceedings were producing, large quantities of oil. (R. 217.)

The division orders on which the oil was run to and paid for by the pipe line companies from April, 1931, until July, 1935 (on which date the Yount-Lee Oil Company transferred the leases to the Stanolind Company) were based on seventy-five per centum to the Yount-Lee Company, fifteen per centum to McLean, and ten per centum to the

lessors. (R. 348.) The Yount-Lee Company settled with McLean monthly, paying him fifteen per cent on the royalty account, and twelve and one-half per cent on the oil payment account. (R. 348.)

After Stanolind's purchase the division orders were based on sixty-two and one-half per cent to Stanolind, and twenty-seven and one-half per cent to McLean—twelve and one-half per cent on the the oil payment account and fifteen per cent on the royalty account. (R. 348.) Settlements were made by that company monthly on this basis. (R. 222.)

Between March 18, 1931, and December 31, 1935, McLean received the following amounts on account of said Two Million Dollar payment (R. 216):

Year.	*Amount.*
1931	$ 7,144.09
1932	109,363.36
1933	127,323.22
1934	189,917.34
1935	105,075.56

The Yount-Lee Oil Company capitalized the cash and the amounts paid to McLean on account of the Two Million Dollar payment, and charged the same on its books to the cost of the leases. (R. 221, 306-312.)

McLean considered the transaction as constituting a sale of capital assets, and in his income tax returns for the years 1931 to 1935, inclusive, reported the cash payment and the amounts collected on the Two Million Dollar payment as capital gains, taxable as provided in Sections 101 of the Revenue

Acts of 1928 and 1932, and Section 117 of the Revenue Acts of 1934. (R. 223.)

Respondent conceded (R. 216), and the Board of Tax Appeals found (R. 182) that McLean did not hold the leases primarily for sale in course of his business (R. 216); and that the leases did not represent stock in trade or other property of a kind which would be included in the inventory if on hand at the close of the taxable year. (R. 182, 216.)

Respondent determined that neither the cash nor the amounts received on account of the Two Million Dollar payment represented *gains* from the *sale* of capital assets, but constituted ordinary income, subject to both normal and surtaxes under Sections 11 and 12 of the Revenue Acts of 1928 and corresponding provisions of the Revenue Acts of 1932 and 1934 (R. 223, 224); and allowed depletion on such payments at the rate of twenty-seven and one-half per centum. (R. 224.)

Respondent further conceded (R. 215), and the Board of Tax Appeals found (R. 182) that the principal value of the leases was demonstrated by prospecting and exploration work done by McLean (R. 215), but further determined that McLean was not entitled to the benefit of Section 102 of the Revenue Acts of 1928 and 1932. (R. 192, 193.)

Based on such determinations and other adjustments immaterial here, respondent determined deficiencies in petitioner's income taxes as follows (R. 205):

Year.	*Amount.*
1931	$10,944.82
1932	45,436.64
1933	20,356.44
1934	37,174.05
1935	18,638.66

The Board of Tax Appeals sustained respondent's determination and the court below affirmed the Board.

4. Specifications of Error to Be Urged.

1. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1928.

2. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1932.

3. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1934.

4. The court below erred in not holding that the cash consideration received by petitioner upon the transfer and assignment of the Cade leases to the Yount-Lee Oil Company on March 18, 1931, constituted gains derived from the sale of capital assets

within the purview of the Capital Gains Provisions of the Revenue Acts of 1928 and 1932.

5. The court below erred in not holding that the amounts received by petitioner during 1931, 1932, 1933, 1934 and 1935 on account of the Two Million Dollar payment, constituted gains derived from the sale of capital assets within the purview of the Revenue Acts of 1928, 1932 and 1934.

6. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a "bona fide sale" within the purview of Section 102 of the Revenue Acts of 1928 and 1932.

7. The court below erred in not holding that the petitioner was entitled to the benefit of Section 102 of the Revenue Acts of 1928 and 1932, with respect to the amounts which petitioner received during the years 1931 to 1933, inclusive, on account of the transfer of the Cade leases to the Yount-Lee Oil Company on March 18, 1931.

B.

Reasons for Granting the Writ.

(1) Oil and gas transactions involve many undecided questions with respect to their status for the purpose of Federal income taxation. This circumstance has been recognized by the Bureau of Internal Revenue of the Treasury Department, and probably prompted it, in June, 1941, to promulgate a memorandum of its views in regard to such trans-

actions. G.C.M. 22,730 (1941-26-10, 755), Appendix B, pp. 40 *et seq.*

In holding that petitioner's reservation and exception of a royalty in excess of that reserved by the lessors, prevented the transaction from being a *sale* within the meaning of that word as used in the Revenue Acts of 1928, 1932 and 1934, the Circuit Court of Appeals decided one of the most important of such questions which have not been directly passed upon but which should and must ultimately be decided by this court.

The Internal Revenue Bureau unmistakeably recognizes that proceeds derived upon the transfer of an economic interest in oil and gas properties may constitute gains within the purview of the Capital Gains Provisions of the Revenue Acts. In the above memorandum Chief Counsel for the Bureau took occasion to point out that,

> "A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss, measured by the difference between cost allocable to the interest sold and proceeds received." (See Appendix B, pp. 40 *et seq.*)

A fortiori, such a transfer may constitute a sale within the meaning of Section 102 of the Revenue Acts of 1928 and 1932.

Prior to his transaction with the Yount-Lee Oil Company on March 18, 1931, the petitioner owned ninety per cent of the oil in the Cade leases. That

interest carried with it the rights and burdens of extraction of the mineral. By the express terms of that transaction he unconditionally transferred to the Young-Lee Oil Company seventy-five per cent of the entire oil interest in the properties, together with the rights and burdens of the development and production—being one hundred per cent ownership and control of the working or operating interest in the leases—*but without obligation with respect thereto, or limitation or reversion on default thereof,* for the sum of Five Hundred Thousand Dollars cash, and that company's promise to pay him Two Million Dollars out of one-eighth of the gross oil produced and saved from the leased premises, "if, as and when produced," translated into cash according to a formula set out in their agreement.

This was not a leasing transaction in which the transferor receives a payment in advance for oil and gas to be extracted in the future, *Herring v. Commissioner of Internal Revenue,* 293 U. S. 322, 324, and which serves merely to diminish his investment but not reduce his economic interest in the oil in place, as does the production of the mineral. The cash which petitioner received, as well as the cash which he was conditionally promised, was paid and promised in return for seventy-five per cent of the economic interest in the oil with which he parted. *Anderson v. Helvering,* 310 U. S. 404 at 409; *Helvering v. Elbe Oil Land Development Co.,* 303 U. S. 372; *Blankenship v. U. S.* 95 F. (2d) 507; *Spalding v. U. S.,* 97 F. (2d) 701.

In effect the transaction accomplished that which

Chief Counsel for the Bureau of Internal Revenue characterizes a "substitution of payor invested capital for payee invested capital" in the properties. In the instant case the petitioner, as the payee, derived gain, measured by the difference between the cost of his interest and the proceeds received.

This Court has held that the transfer of an interest in oil leases was no less a sale because the transferor withheld from the operation of the grant a specified portion of the oil to be produced and saved, up to an amount sufficient when sold to yield a specified sum of money. *Thomas v. Perkins,* 301 U. S. 655. By the same token, petitioner's reservation and exception from his transfer of a portion of the economic interest owned on the date of the transaction in no way prevented his transaction from being an absolute sale of that portion of the interest which he gave up, and which the Yount-Lee Oil Company in turn acquired and owned as a result thereof, and over which it exercised unlimited power and control.

The decision of the court below that petitioner's retention of a portion of the interest originally owned prevented the transaction from constituting a sale, is equivalent to holding that owners of a leasehold estate in oil and gas, which carries with it the right and burden of extraction of the mineral, but without obligation with respect thereto, cannot effect a sale of a *portion* of such interest; that, irrespective of the intention of the parties at the time of the transaction, and the construction they thereafter place upon it, the retention of an economic interest

in the oil for the duration of the lease converts into a leasing transaction that which would otherwise constitute a sale.

There is nothing in the opinions of this Court in *Palmer v. Bender*, 287 U. S. 551, or *Burnet v. Harmel*, 287 U. S. 103, from which such conclusion can be drawn. Both cases arose out of factual situations and presented questions readily distinguishable from the instant case. Such conclusion conflicts with the reasoning of this Court in *Thomas v. Perkins, supra; Helvering v. Elbe Oil Land Development Co., supra*, and *Anderson v. Helvering, supra*. Moreover, such a "rule" clearly denies to owners of such interest not only the benefit of the capital gains provisions of the Revenue Acts, which other taxpayers enjoy without such restrictions, but in addition, in disregard of established principles of income taxation, announced by this Court in *Bonwit-Teller & Co. v. U. S.*, 283 U. S. 258, 263, puts beyond reach of the discoverer of oil the relief which Congress by Sections 102 of the Revenue Acts of 1928 and 1932[3], clearly intended he should receive as a reward for his unrelenting efforts and risk of capital.

These matters are clearly of such public importance that there should be an authoritative decision of this Court on the questions they present.

(2) The holding of the court below that this Court held in *Palmer v. Bender*, 287 U. S. 551, that the exception and reservation of an economic interest in a transaction such as petitioner made with Yount-Lee Oil Company, prevented the same from

[3] I. R. C., Sec. 117.

being a "sale" within the purview of the Capital Gains Provisions of the Revenue Acts of 1928, 1932 and 1934, and Section 102 of the Revenue Acts of 1928 and 1932, is an improper interpretation and misapplication of the decision in that case, deserving review and correction by this Court. This Court did not there decide that the exception or reservation of an economic interest in the oil was a deciding factor in determining whether or not such a transaction constituted a "sale" or sublease. That case involved the right of the transferor of certain oil leases to deductions for discovery depletion upon cash and oil payments received, and royalty reserved under the terms of two oil lease transactions. The Government rested its denial of the deductions upon the premise that the transactions were sales or assignments. The taxpayer contended that they were subleases, and that the cash received was an advance payment on account of royalty to be paid on oil to be produced. The decision sustained the taxpayer.

In one of the transactions (the Smitherman Partnership to the Ohio Oil Company), the assignee paid the partnership, on execution of the instrument by which the transaction was memorialized, cash in the amount of Three Million Dollars; agreed to pay One Million Dollars out of oil, and further covenanted to perform the terms and covenants of the lease (which ordinarily include provisions with respect to the exploitation, development and operation of the properties), and "to pay over and deliver unto assignors * * * the equal one-eighth of all oil

produced and saved from * * * the premises as an excess royalty, whether produced under the * * * lease contract or under any extension, renewal or other contractual obligation entered into * * * with the lessors, his heirs or assigns."

These provisions closely resembled the terms of conventional oil and gas leases; created a relationship between the parties comparable to that between lessor and lessee, and marked the transaction as a sublease as urged by the taxpayer. Accordingly, this Court held that, "the bonus received by the Smitherman Partnership was a return *pro tanto* of petitioner's capital investment in the oil, an anticipation of its extraction, resulting in a corresponding diminution of the unit depletion allowance upon the royalty oil as produced."

This Court did not hold that the payment of a cash consideration for the transfer of an oil lease in which assignor excepted or reserved a royalty—as a matter of law—prevented the transaction from constituting a sale within the meaning of the Capital Gains Provisions of the Revenue Acts.

Cash payments are regarded as advance royalties only in leasing transactions (*Anderson v. Commissioner of Int. Rev.*, 310 U. S. 404, 409); never in sales. (*Thomas v. Perkins*, 301 U. S. 655; *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372.) Whether the transaction falls within the category of the one or the other must be determined from the substance of the transaction, not from the form of the economic interest excepted or the oil payments stipulated. These are looked to for deter-

mining "who has a capital investment in the oil and gas in place, and what is the extent of his interest." *Anderson v. Helvering, supra,* at 407.

In the instant case the assignee was free of any obligation to perform the terms and covenants of the lease, and expressly relieved of any obligation to drill upon or develop the land or any part thereof. Nor was there any stipulation in the agreement that the assignee should pay McLean, as excess royalty, a specified share of the oil to be produced, whether produced under the leases transferred or any extension, renewal or other contractual obligations between the assignee and the landowners. Instead, petitioner excepted and reserved from his grant a "royalty of twenty-five per cent of the oil produced and saved * * * out of which * * * all outstanding royalties (including royalties due lessors under the terms of said lease) and all overriding royalties were to be paid."

The opinion of the court below clearly manifests its misinterpretation of the decisions of this Court in *Palmer v. Bender, supra,* and the other cases above cited. That interpretation has led it into conflict not only with the decisions of this Court in these cases but with its own decisions in *Commissioner of Internal Revenue v. Fleming,* 82 F. (2d) 324; and *Commissioner of Internal Revenue v. Roeser & Pendleton, Inc.,* 118 F. (2d) 462.

(3) When the transaction between petitioner and the Yount-Lee Company is tested by the uniform rules of decision of all the courts, state and federal, and by the pronouncements of all the text authori-

ties defining the constituent elements of a sale, as contradistinguished from any other type of transfer, the fact that it was a sale by petitioner of a specified economic interest in oil and gas properties is apparent. Nevertheless, the court below, after correctly detailing the facts constituting the sales transaction, and the construction placed upon their contract by the parties to it, as evidenced by their acts in carrying out its express and unambiguous terms, in summation said, "There was no sale here."

The conclusion thus stated is a *non sequitur*, and is in direct conflict with fundamental principles consistently applied in the administration of the income tax laws. As said by the Circuit Court of Appeals for the Ninth Circuit in *First Seattle Dexter Horton Nat'l Bank et al. v. Comm'r*, 77 Fed. (2d) 45, at pages 47-48:

> "In passing upon the question of whether or not the contract is severable or entire, it is fundamental that the intention of the parties should be looked to, and that the contract should be construed so as to effectuate such intention so far as the bounds of reason and justice permit. Obviously, courts cannot possibly know or judge what the parties may have intended to accomplish but failed to expressly provide for, and therefore such intention must be ascertained by a fair construction of the terms of the contract itself. So where parties enter into a written agreement which embodies and sets forth in full all the terms and conditions of the contract, their intentions must necessarily be determined from and governed by the language they have employed in such writing, and from the subject-matter of the agreement. To do otherwise would

be to frustrate the very end for which people contract in writing."

The Circuit Court of Appeals for the Third Circuit stated and applied the rule in *Jefferson Coal and Gas Company v. Comm'r,* 52 F. (2d) 120, at page 122:

> "* * * the real character of an instrument must be determined from the intention of the parties as gathered from a fair interpretation of the instrument as a whole (citing authorities). Looking at the instrument as a whole, and the object sought to be obtained, that it is a contract of sale of coal in place and not a lease is inescapable."

And this Court has affirmed and reaffirmed the doctrine that transactions must be examined as to their substance:

> "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the 16th Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have, under varying conditions, followed the rule." (Citing previous decisions.) *United States of America v. Phellis,* 257 U. S. 156, 168.
>
> "* * * the rule is well settled that in determining tax liability, taxing authorities must look through form to fact and substance." *Helvering v. Tex-Penn Oil Co. et al.,* 300 U. S. 481, at 492.

Thus predicated upon an unauthorized and arbitrary conclusion, in conflict with such established principles, and in disregard of the substance of the

transaction, the court below denied petitioner the benefit of Sections 101 and 102 of the Revenue Acts of 1928 and 1932, and Section 117 of the Revenue Act of 1934, which the Congress clearly intended the vendor of capital assets should receive, and deprived petitioner of the express relief which the Congress intended that discoverers of oil should be accorded upon realization of success after years of fruitless prospecting and exploration; and, in addition, penalized petitioner with a large deficiency imposed by the respondent.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court, directed to the United States Circuit Court of Appeals for the Fifth Circuit, commanding that court to certify and send to this Court a full and complete Transcript of the Record and all the proceedings in this case, being number 9870 in said Circuit Court of Appeals, to the end that said cause may be reviewed and determined by this Court, and that your petitioner have such other and further relief as to this Court may seem appropriate and in conformity with law.

MARRS MCLEAN,
Petitioner,
By L. J. BENCKENSTEIN,
His Attorney.

Dated at:
Beaumont, Texas,
September 10, 1941.

IN THE

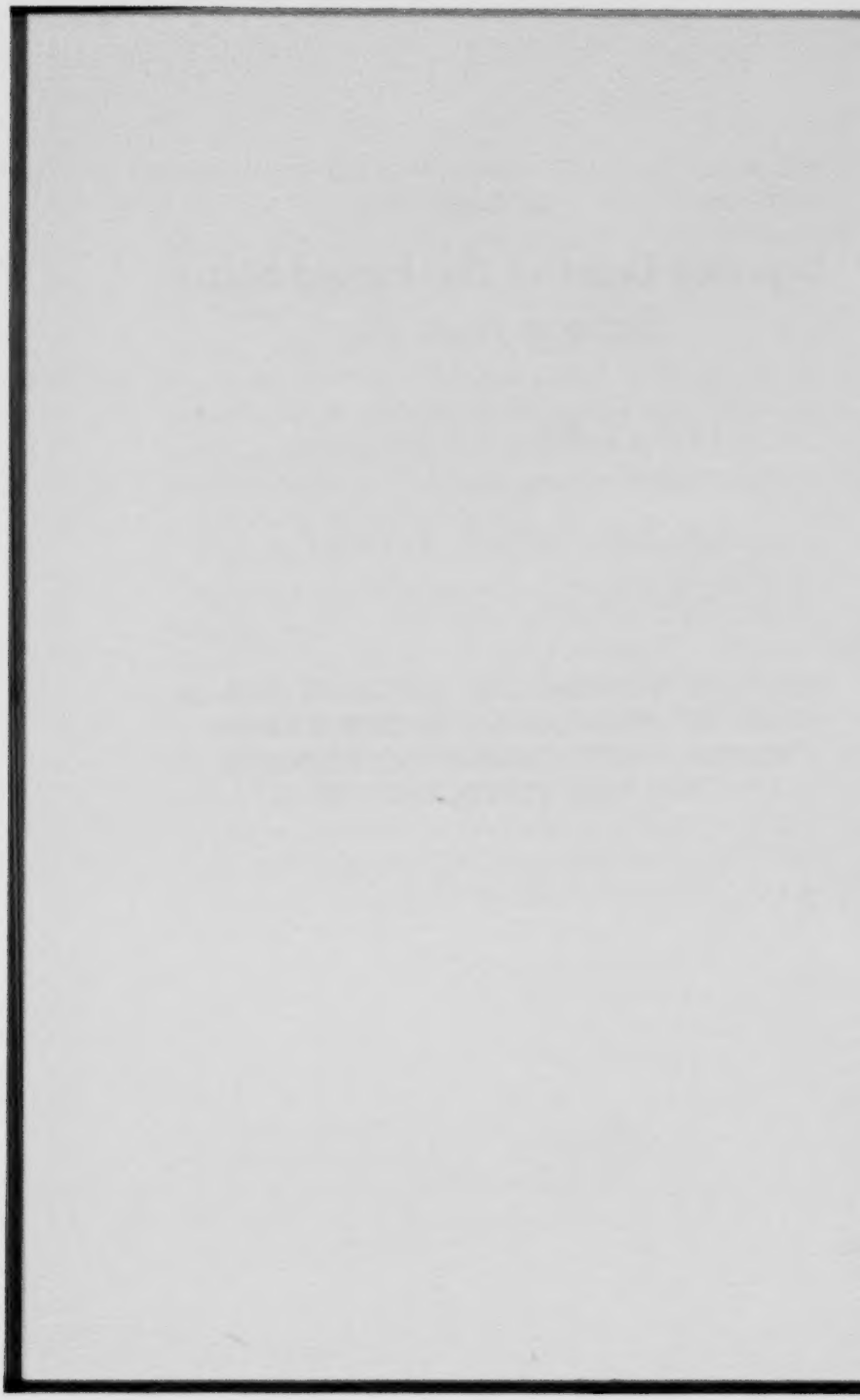
Supreme Court of the United States

OCTOBER TERM, 1941

NO......

MARRS McLEAN, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT



IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

NO......

MARRS McLEAN, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

I.

OPINION BELOW.

The opinion of the Circuit Court of Appeals for the Fifth Circuit is reported in 120 F. (2d) 942. (R. 353.)

II.

JURISDICTION.

The jurisdiction of this court is invoked on the following grounds:

(1) The judgment to be reviewed was entered on June 20, 1941. (R. 353.)

(2) The Board of Tax Appeals had jurisdiction of this case under Section 274(a) of the Revenue Act of 1926 (44 Stat. 55), as amended by Section 501 of the Revenue Act of 1934 (48 Stat. 755); I. R. C. 272. The appeal to the Circuit Court of Appeals was taken in pursuance of Section 1141 I. R. C.

(3) The jurisdiction of this court is invoked under Section 240(a) of the judicial Code, as amended by Act of February 13, 1925. (43 Stat. 938.)

(4) Under Rule 38(5) of this Court, a review on writ of certiorari will be granted where there are special and important reasons therefor. There are special and important reasons why this cause should be reviewed by this Court. Those reasons are set forth in the petition (*supra*, pp. 8-18), and in the interest of brevity will not be repeated here.

III.

STATEMENT OF THE CASE.

The essential facts of the case are fully stated in the petitioner's petition for certiorari, and in the interest of brevity are not repeated here. Any necessary elaboration of the evidence on the points involved will be made in course of the argument which follows.

IV.

The pertinent Statutes involved are set out in the appendix A, *infra,* pp. 37-39.

V.

SPECIFICATIONS OF ERROR.

1. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1928.

2. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1932.

3. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Rvenue Act of 1934.

4. The court below erred in not holding that the cash consideration received by petitioner upon the transfer and assignment of the Cade leases to the Yount-Lee Oil Company on March 18, 1931, constituted gains derived from the sale of capital assets within the purview of the Capital Gains Provisions of the Revenue Acts of 1928 and 1932.

5. The court below erred in not holding that the amounts received by petitioner during 1931, 1932, 1933, 1934 and 1935 on account of the Two Million

Dollar payment, constituted gains derived from the sale of capital assets within the purview of the Revenue Acts of 1928, 1932 and 1934.

6. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a "bona fide sale" within the purview of Section 102 of the Revenue Acts of 1928 and 1932.

7. The court below erred in not holding that the petitioner was entitled to the benefit of Section 102 of the Revenue Acts of 1928 and 1932, with respect to the amounts which petitioner received during the years 1931 to 1933, inclusive, on accocunt of the transfer of the Cade leases to the Yount-Lee Oil Company on March 18, 1931.

VI.

ARGUMENT.

The primary question presented by the decision of the Circuit Court for the Fifth Circuit in the instant case is whether petitioner's reservation of a royalty prevented his unconditional transfer of certain oil leases from constituting a *"sale"* within the purview of Sections 101 and 102 of the Revenue Acts of 1928 and 1932, and Section 117 of the Revenue Act of 1934.

Similar provisions are embodied in the Internal Revenue Code as Sections 105 and 117.

That the question presented is of public importance deserving review and authoritative decision is clearly shown by the promulgation of a memoran-

dum by General Counsel of the Bureau of Internal Revenue in June of this year (G.C.M. No. 22730), setting forth the Bureau's views in regard to this and other undecided questions arising out of oil and gas transactions.

1.

The Word "Sale" Should Be Given Its Ordinary Meaning.

There is nothing in the capital gains provisions of the Revenue Acts here involved, nor in similar provisions of any of the other Revenue Acts, which remotely indicates that Congress intended that the word *"sale"* was employed other than in its natural, ordinary and familiar sense.

Helvering v. Wm. Flaccus Oak Leather Co., (U. S. Sup. Ct. No. 627) Apr. 28, 1941.
Burnet v. Harmel, 287 U. S. 103, 108, 110.

Nor is there anything in the "Prospectors' Relief" provision (Sec. 102) of the Revenue Acts of 1928 and 1932, or the later Acts, which contains similar provisions for relief of those who, after years of fruitless prospecting and exploration, succeed in discovering oil upon their leases, which implies that the Congress intended that the word *"sale"* was used other than in its common meaning and ordinary sense.

Fowler v. U. S., 11 F. (2d) 895.
1 Paul & Mertens, p. 22, Sec. 2.05.

When given its ordinary meaning the word de-

notes "a contract whereby the absolute or general ownership of property is transferred from one person to another for a price or sum of money, or loosely, for any consideration." (Webster's New International Dictionary.) Or any transaction whereby property is parted with for a valuable consideration, whether there be a money payment or not, provided the bargain is made and the value measured in money terms is paid or agreed to be paid in something which the parties agree to treat as a specified amount of money. 23 C. J. 185. These definitions have received the repeated approval of this Court.

Williamson v. Berry, 8 Howard 495; 543.
Five Per Cent Cases, 110 U. S. 471.

2.

The Transaction Was Clearly a Sale.

On March 18, 1931, petitioner was the owner of certain oil and mineral leases in Galveston County, Texas, upon which he had, after years of effort and risk, succeeded in discovering oil in commercial quantities. (R. 215)

There can be no doubt that as the owner of such leases McLean was the owner of vendable real property.

Lynch v. Alworth-Stephens Co., 267 U. S. 364, 369.
Comm'r of Int. Rev., v. Fleming, 82 F. (2d) 324, 327.

On that day he transferred to the Yount-Lee Oil

Company, for a stipulated consideration, the title, possession and absolute ownership and control of the leases without restriction or limitation as to use, or provision for reversion, together with all oil well producing and operating equipment thereon, but less and except a twenty-five per cent royalty in the oil to be produced therefrom, out of which all outstanding royalties were to be paid, including that due the lessors.

The paper by which this transaction was memorialized recites that McLean is the *owner* of certain oil and mineral leases in Galveston County, Texas, and declares that,

> "* * * for the consideration hereinafter set forth (and subject to royalty reservation hereinafter contained), have GRANTED, SOLD, CONVEYED, TRANSFERRED AND ASSIGNED, and do by these presents GRANT, SELL, CONVEY, TRANSFER AND ASSIGN unto the Yount-Lee Oil Company * * * the following described oil, gas and mineral leases and the oil, gas and mineral leasehold estates created thereby (together with the hereinafter described physical properties and equipment), covering the following described lands in Galveston County, Texas, to-wit: * * *"

Following a description of the leases and the physical properties and equipment thereon, the instrument recites:

> "The *consideration* for this transfer and assignment of said above-described oil, gas and mineral leases and physical properties and equipment, is as follows:
> "(a) The sum of ONE HUNDRED THOU-

SAND ($100,000.00) DOLLARS CASH, * * *

"(b) TWO HUNDRED THOUSAND ($200,000.00) DOLLARS due and payable six (6) months after the date hereof, and TWO HUNDRED THOUSAND ($200,000.00) DOLLARS due and payable twelve (12) months after the date hereof; said deferred payment to bear no interest;

"(c) TWO MILLION ($2,000,000.00) DOLLARS to be paid out of one-eighth (1/8) of the (gross) oil produced and saved from the lands covered by the assignment, if, as and when produced and saved, and only in such event; it being expressly understood in this connection that said *YOUNT-LEE OIL COMPANY shall be under no obligation whatever to Grantor herein to drill upon or develop said land, or any part thereof, for oil.*" (Italics supplied.)

The "royalty reservation" referred to in the granting clause of the conveyance is provided for in the next paragraph of the instrument which also assured the Yount-Lee Oil Company of seventy-five per cent of the oil produced, without diminution by any outstanding royalties, over-riding royalties and/or interest of any character in the oil in, under or produced from the land. It recites:

"There is reserved and excepted from this assignment a royalty of twenty-five (25%) per cent of the oil produced and saved from the lands covered by this assignment, out of which twenty-five (25%) per cent royalty all outstanding royalties, (including royalties due lessors under the terms of said leases) and all overriding royalties are to be paid, and Grantor is to receive the balance of said twenty-five

(25%) per cent royalty; it being understood in this connection that said YOUNT-LEE OIL COMPANY shall in any event be entitled to receive seventy-five (75%) per cent of the oil produced and saved from said land, and that all outstanding royalties, overriding royalties, and/or interest of any character in the oil in, under or produced from said land shall be charged against the twenty-five (25%) per cent royalty herein reserved. Said YOUNT-LEE OIL COMPANY shall be entitled to free fuel oil for all operations on said land and the royalty shall be computed after deducting oil used for fuel. Grantor also reserves a royalty of twenty-five (25c) cents per long ton on sulphur but Grantor shall be under no obligation to develop said land for sulphur."

The next paragraph of the conveyance sets out a formula for pricing the oil produced from the land, for the purpose of calculating the amount to be currently applied against the Two Million Dollar payment, and for accounting to McLean for his share of the reserved royalty oil. It declares that:

"If oil is produced from the land covered by this assignment and said YOUNT-LEE OIL COMPANY runs such oil to its pipe line or to its storage (other than field tanks and temporary storage in the High Island field) then said Yount-Lee Oil Company is to account to Grantor, on the payment to be made to him out of oil and for his interest in the royalty oil, on the basis of the posted field price at the well in the Gulf Coast for oil of like grade and gravity posted by the following four (4) major pipe line companies: The Texas Pipe Line Company, Gulf Pipe Line Company, Humble Oil & Refin-

ing Company and Sun Pipe Line Company. In the event said Yount-Lee Oil Company *sells the oil produced from said land to others,* said YOUNT-LEE OIL COMPANY *shall account to Grantor* on the payment to be made to him out of oil and for his interest in the royalty oil, on the basis of the sale price at the well received by the said YOUNT-LEE OIL COMPANY." (Italics supplied.)

The habendum clause, which follows the foregoing provision, employs language identical with that used in such provisions containing the usual Texas general warranty clause. It follows:

"TO HAVE AND TO HOLD said above-described oil, gas and mineral leases and the mineral leasehold estates created thereby, and the physical properties and equipment above described, together with all and singular the rights and appurtenances, thereunto in anywise belonging, unto the said YOUNT-LEE OIL COMPANY, its successors and assigns, and I do hereby for myself, my heirs, executors and administrators, COVENANT AND WARRANT that I have full right to convey said above-described oil, gas and mineral leases and that each of said leases are not* encumbered, valid and in full force and effect; and I further hereby bind myself, my heirs, executors and administrators, to WARRANT AND FOREVER DEFEND all and singular the title to the land covered by said oil, gas and mineral leases unto the said YOUNT-LEE OIL COMPANY, its successors and assigns, against every person whomsoever lawfully claiming or to

* In the Stipulation of Facts, page 15, line 5, this word erroneously appears as "now."

claim the same, or any part thereof." (Italics supplied.)

The conveyance was executed in the usual Texas form, and is as follows:

"EXECUTED this 18th day of March, A.D. 1931.

/S/ MARRS McLEAN
YOUNT-LEE OIL COMPANY,
By /S/ M. F. YOUNT,
President.
Attest:
(Seal) /S/ F. E. THOMAS,
Asst. Secretary."

The foregoing instrument conforms with the statutory provisions of the State of Texas for the conveyance of real property. (R. 225.)

There is nothing within its four corners which remotely indicates that the parties intended to create as between themselves a relationship such as obtains between lessor and lessee. On the other hand, every term and provision thereof manifests the unequivocal intention of the parties to effect an unconditional transfer from McLean to the Yount-Lee Oil Company of the title, possession, ownership and control of the leases and the equipment thereon, less and except a twenty-five per cent economic interest in the oil in place, out of which all royalties were to be paid.

It is a fundamental principle of general law, consistently applied in the administration of the income tax acts, that where "parties enter into a written agreement which embodies and sets forth in full all the terms and conditions of their contract, their

intentions must necessarily be determined from and governed by such writing," and their "contract construed so as to effectuate such intention so far as the bounds of reason and justice will permit."

> First Seattle Dexter Horton Nat'l Bank, et al., v. Commissioner of Internal Revenue, 77 F. (2d) 45, 48, ~~(Cert. den. ——)~~.
> Jefferson Gas & Coal Co. v. Commissioner of Internal Revenue, 52 F. (2d) 120.

Any other rule would "frustrate the very ends for which parties contract in writing," *First Seattle Dexter Horton Nat'l Bank, et al., v. Commissioner of Internal Revenue,* 77 F. (2d) 45, 48, and substitute for the transaction they created one with legal and economic consequences flowing therefrom wholly different from that which they intended, and in conflict with the construction which they placed upon it in dealings between themselves and with third parties. (R. 348.)

3.

The Opinion Below is An Erroneous Interpretation and Improper Application of the Decisions of This Court.

The Circuit Court of Appeals held the transaction to be a sublease on the premise that petitioner's reservation of a royalty prevented the transaction from constituting a sale within the meaning of Sections 101 and 102 of the Revenue Acts of 1928 and 1932, and Section 117 of the Revenue Act of 1934. It is clear from the opinion of the court that its

decision rests entirely upon an erroneous interpretation and improper application of this court's decision in *Palmer v. Bender, supra.* The opinion states in part:

> "Precisely as in Palmer v. Bender, the taxpayer here, in the instrument of transfer reserved in himself an interest in the oil in place, and thereby and as a result thereof, secured for himself, 'income derived from the extraction of the oil to which he must look for a return of his capital.'
>
> "Precisely, as in Palmer's case, the taxpayer here retained a right to share in the oil to be produced, and an economic interest in the oil in place, which is depleted by production. Precisely as in that case, the taxpayer obtained as part consideration, for letting the sublessee in, a part of the fruits of the land as they might be produced, both as to the royalty and as to the payments in oil."

The same can be said of the transactions involved in *Thomas v. Perkins,* 301 *U. S.* 655; *Helvering v. Elbe Oil Land Development Co.,* 303 *U. S.* 372, *and Anderson v. Helvering,* 310 *U. S.* 404.

These decisions make it clear that provisions with respect to the reservation of royalty and stipulations for payment in oil are looked to solely for the purpose of determining "who has a capital investment in the oil and gas in place and what is the extent of his interest" *Anderson v. Helvering, supra,* at 407; never for the purpose of determining whether the transaction constituted a sale under the provisions of the Revenue Acts involved. Cf. *Helvering v. Elbe Oil Land Development Co., supra.*

The primary question in the *Palmer* case was whether or not the transferor of certain oil leases was entitled, under Section 214(a) of the Revenue Act of 1921, to deductions for discovery depletion upon cash, oil payments and royalties received under the terms of his transfers. The Government rested its denial of the deductions upon the ground that the amounts against which depletion was claimed represented proceeds from the sale of leases. The taxpayer contended that the transactions were subleases, and the cash an advance payment on account of royalties to be paid on oil to be produced. This Court sustained the taxpayer.

The decision did not turn upon the stipulation for oil payments and reservation of royalties, but was predicated upon a practical construction of the terms and provisions of the instruments of transfer and the percentage depletion statute involved. In the Smitherman transaction, under review in the Palmer Case, the terms and provisions with respect to performance of the conditions of the leases transferred, and the payment of an excess royalty, resembled the terms of a conventional oil lease; and created a relationship between the parties comparable to that which obtains between lessor and lessee, with legal and economic consequences which characterize such relationships. These circumstances marked the transaction as a sublease, as contended for by the taxpayer. This Court so held.

In the instant case the assignee was free of any obligation to perform the terms and covenants of the leases, and expressly relieved of any obligation

to drill upon or develop the land or any part thereof. Nor was there any stipulation in the agreement that the assignee should pay McLean as excess royalty a specified share of the oil to be produced. Petitioner simply excepted and reserved from his grant a "royalty of twenty-five per cent of the oil produced and saved * * * out of which * * * all outstanding royalties (including royalties due lessor under the terms of said lease) and all overriding royalties were to be paid."

These terms and provisions unmistakably show that it was the intention of the parties that McLean unconditionally divest himself of the Cade leases, the equipment thereon, and seventy-five per cent of the oil to be produced therefrom. The practical consequence thereof was to create a relationship such as obtains between vendor and vendee, and no other.

The court below overlooked that these circumstances and the practical consequences flowing therefrom distinguish the transaction in the instant case from that before the Court in *Palmer v. Bender, supra.*

In the Statutes and Treasury Regulations, and the opinion in *Palmer v. Bender, supra,* the word "royalties" is used in its plural and inclusive sense. It is evidence from the opinion of the court below that it has subdivided "royalties" into "royalty," (in its singular sense) and "oil payment," and given to each a value in determining the nature of the transaction. Cf. *Anderson v. Helvering, supra.*

It was upon this erroneous interpretation and

improper application of the decision in *Palmer v. Bender, supra,* that the court below was led to hold that the reservation of a royalty by the transfer of an oil and gas lease prevents the transaction from constituting a sale within the purview of the "Capital Gains" and "Prospectors' Relief" provisions of the Revenue Acts.

Such a rule not only conflicts with the decisions of this Court with respect to the basis for determining the nature of such transactions for the purpose of income taxation, but in addition, gives to the word *"sale"* a strange and unusual meaning—in conflict with the common understanding and accepted denotation of that word as approved by this Court—and, moreover, deprives owners of oil and gas leaseholds of the benefits enjoyed by all other taxpayers, free of such restrictions and limitations. That the Congress did not intend to deny to such owners the benefits of these provisions of the Act is not open to doubt or dispute.

CONCLUSION.

It is, therefore, respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, to the end that a writ of certiorari should be granted, and that this Court should review the decision of the Circuit Court of Appeals and reverse and modify it in the particulars mentioned, as the rights of petitioner require.

L. J. BENCKENSTEIN,
Attorney for Petitioner.

APPENDIX A.

STATUTES INVOLVED

Revenue Acts of 1928 and 1932.

SECTION 101. (*a*) *Tax in case of capital net gain:* In the case of any taxpayer, other than a corporation, who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, at the election of the taxpayer, be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½ per centum of the capital net gain. * * *

(*c*) *Definitions:* For the purpose of this title—

(*c*) (1) "Capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921. * * *

(c) (6) "Capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain.

(*c*) (7) "Ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions.

(*c*) (8) "Capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included

in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

SECTION 102. *Sale of Mines and Oil or Gas Wells.*

(*a*) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by section 12 of this title attributable to such sale shall not exceed 16 per centum of the selling price of such property or interest.

(*b*) For limitation to 12½ per centum rate of tax, see section 101.

Revenue Act of 1934.

SECTION 117. (*a*) *General Rule:* In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(*b*) *Definition of Capital Assets:* For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(*c*) *Determination of Period for Which Held:* For the purpose of subsection (*a*)—

(*c*) (1) In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(*c*) (2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

APPENDIX B.

"*G. C. M.* 22730, 1941-26-10755 (p. 3).

Internal Revenue Code and Prior Revenue Laws.

(*Oil and gas leases: Tax status.*) *Status of oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.*

See Sec. 19.23(m)-1 at 411 CCH P227-240.

An opinion is requested with respect to the status of oil and gas leasing transactions for Federal income tax purposes, the acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

The following supposititious case presenting the questions involved may be stated for convenient consideration. A, as a fee owner of oil lands, leased the lands to B in consideration of a cash payment of $100,000, an additional $100,000 payable out of one-sixteenth of the oil and gas if, as, and when produced, and a one-eighth royalty interest. B then assigned his leasehold interest to C in consideration of a cash payment of $200,000, and an additional $100,000, payable only out of one-sixteenth of the oil and gas if, as, and when produced. C assigned one-half of the lessee interest to D, who agreed to

develop and operate the property, to advance C's share of the funds necessary for development costs and operating expenses, to sell all the oil produced and saved and credit C with one-half of the proceeds until all advances were fully recouped, and thereafter to operate the property and pay one-half of the proceeds from the sale of all oil produced, less one-half of the operating expenses, to C, who was not personally liable for any costs or expenses incurred or advances made. E drilled an oil well under an agreement with D entitling E to have delivered to his credit one-eighth of all the first oil and/or gas if, as, and only when the same is produced, saved, and marketed from the land until he received the sum of $25,000. Also, F paid D the sum of $15,000, which D covenanted to use in developing the property, and D agreed to pay F the sum of $25,000, payable out of one-eighth of the oil and/or gas if, as, and only when the same is produced, saved, and marketed from the leased land.

In *Lynch v. Alworth-Stephens Co.* (267 U. S., 364, T. D. 3690, C. B. IV-1, 162 (1925) (1 USTC P 117, 5 USTC P 1615) and cases therein cited, the United States Supreme Court, though it expressly recognized the hardship involved in treating all proceeds from the extraction and sale of ore as ordinary income in view of the fact that mining operations reduce the value of property interests in mineral deposits, made it clear that such reduction in value is not depreciation but depletion, and that the capital investments in minerals of both the lessor and the lessee are returnable to them tax-free only through

depletion deductions expressly granted by statute. (See also *Helvering v. Mountain Producers Corporation,* 303 U. S. 376, *Ct. D.* 1321, C. B. 1938-1, 343 (38-1 USTC P 9153), wherein the Court stated that the depletion allowance rests upon legislative grace.)

Though the Revenue Act of 1916 did not expressly provide for the allocation of depletion between the parties in interest, the Court in the Alworth-Stephens case regarded both the lessor and lessee of mining property as owning valuable property rights in the mineral in place which were reduced in value through the extraction of ore, and it held the total depletion allowable was allocable between the lessor and the lessee in proportion to the interests of each severally considered.

Subsequent decisions hold that the incidental exhaustion of natural deposits through the production and sale of oil or minerals is not a sale or conversion of capital assets allowing cost or basic value to be recovered tax-free. Further, a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed (hereinafter referred to as a "bonus") and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold (hereinafter referred to as "royalties") which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation. (See *Bankers Pocahontas Coal Co. v. Burnet,* 287 *U. S.,* 308, *Ct. D.* 618, C. B. XXII-1, 272 (1933) (3 USTC P 998, and

Burnet v. Harmel 287 *U. S.*, 103, *Ct., D.* 611, C. B. XI-2, 210 (1932) (3 USTC P 990), involving ordinary royalties paid a lessor of coal lands on the basis of a fixed amount per ton mined, and a bonus paid the lessor of oil lands, respectively.) The Court thus not only recognized that royalty payments like rental payments are ordinary income to the lessor, but drew an analogy between cash bonus payments made upon the execution of an oil and gas or mining lease and a substantial payment received in the first year by a lessor in any other type of lease for purposes of classifying such bonus payments as ordinary income rather than proceeds from the sale of capital assets.

Such classification of bonus payments does not depend upon whether the local law regards the agreement between lessor and lessee as a lease or a sale of natural resources in place. In *Palmer v. Bender* (287 *U. S.*, 551, *Ct. D.* 641) C. B. XIII-1, 235 (1933) (3 USTC P 1026) the Court refused to distinguish between lessors and sublessors or assignors of leasehold interest who, by stipulation for royalty payments, reserve an interest in production coextensive with the leasehold life. The taxpayer therein was a member of several partnerships, each of which had acquired an oil lease, had discovered oil, and had then assigned the lease to a third party in consideration of a bonus payment, a future payment of a stated sum to be made out of one-half of the first oil produced and saved (which type of payment will hereinafter be referred to as an "oil payment"), an interest which does not by its terms

extend throughout the lease life, and an additional "excess royalty" of one-eighth of all of the oil produced and saved. The Court held that the bonus payment, the oil payments, and the royalty payments were ordinary income to the sublessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets. The Court refused to distinguish between leases governed by varying State laws which apply different rules as to when technical title to oil and gas passes to the lessee, on the ground that the economic consequences to the lessor are the same in all cases—i. e., the value of his interest is lessened by the extraction of oil. The Court stressed the general view that all persons having a right to share in the oil produced or the proceeds from its sale, irrespective of the legal form of their interest in the property, have an economic interest in the oil and gas in place to which the depletion provisions are applicable, the language of the statute, providing that the depletion allowance shall be allocated between lessor and lessee, being held to be broad enough to provide, at least, for every case in which the taxpayer has acquired by investment any interest in the oil in place, or has secured, by any form of legal relation, income derived from the extraction of oil to which he must look for a return of his capital. The opinion states that a lessor, or sublessor or assignor, who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil and gas in place entitling him to depletion deductions against cash

bonus payments as well as proceeds from his share of the oil. The opinion implies that the proceeds from the sale of any share in the oil produced are income subject to depletion in the hands of the one entitled to such share. Further, the Court speaks of the oil and gas in place as a reservoir of the capital investments of the several parties entitled by agreement to share in the oil and gas produced under the lease.

Such language indicates that the Court regarded the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation. If the lessee in turn subleases or assigns the working interest, reserving a royalty share, he acquires a status comparable to that of a lessor with respect to the share retained, any further burden of exploitation being passed on to the sublessee or assignee with an agreed share in the oil and gas produced. So considered, the

view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest upon the the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him. Thus, in the classification of royalty payments as "rent" to the lessor, the term is employed as denoting a sharing by the lessor for the use of his land rather than as an amount owing and paid by the lessee. A cash bonus, though termed an advance royalty payment, paid to a lessor without regard to production and often in a year when there is no production, is not a division of products or proceeds therefrom. Nor, as already noted, does it represent proceeds from the sale of a capital asset to a lessor reserving a royalty interest. The lessor does not sell an interest to the lessee. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property.

The analogy between the bonus payment accompanying a mineral lease and a large payment made in the first year of any ordinary lease, to which the Court resorted to characterize the bonus payment as ordinary income as distinguished from capital gain to the lessor, does not establish an identity of character in the two types of payments for Fed-

eral income tax purposes. An oil or mineral lease differs from an ordinary land lease in that it contemplates severance and disposition of valuable mineral deposits that normally represent a large percentage of land values. Further, the allowance of depletion deductions to the lessor, which serve to offset his bonus income and reduce the basis of his interest, establishes the distinction between such payments by treating the bonus payment upon an oil or mineral lease as, in part, a tax-free return of the lessor's capital investment in mineral in place. As the mineral in place is the reservoir of the capital investments of the parties returnable through the depletion allowance, and as the bonus payment results in a reduction in the lessor's capital investment to the extent of the depletion allowable thereon, it follows that such payment is a contribution by the lessee to such reservoir of capital investments which is substituted for the capital thereby withdrawn by the lessor. Such shifting of capital investment is attended by a corresponding shift in the value of the respective capital interests or share rights of the parties. That is, a bonus payment diminishes the value of the lessor's mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income is designed to compensate him for such diminution in value of his interest thereby sustained. Correspondingly, the bonus payment enhances the value of the lessee's interest by giving him a larger share of the minerals produced, or the proceeds therefrom, by reason of his bonus investment.

It will be noted that the analogy between a bonus payment made upon the execution of an oil or mineral lease and a large rental payment made in the first year of any ordinary lease, upon which the Supreme Court based its conclusion that such bonus payment was ordinary income in the nature of an advance royalty payment subject to the depletion allowance rather than proceeds from the sale of a capital asset, is not available to permit of like treatment of a cash payment made where no royalty right is reserved by the payee. Royalty rights represent a share in all of the oil or mineral in place, and a bonus payment which reduces the royalty and, therefore, the lessor's capital interest in every unit of oil or mineral content may properly be termed an advance royalty. Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him. (See Commissioner v. Fleming, 82 Fed. (2d), 324 (36-1 USTC P 9165).)

It thus appears that (1) agreements to pay royalties measured by a fraction of the mineral product or the proceeds therefrom, or by a stated sum per unit extracted and sold, in effect divide the pro-

ceeds from production, and (2) cash bonus payments representing advance royalty payments effect a substitution in the reservoir of capital investments of lessee invested capital for invested capital withdrawn by the lessor in the amount of depletion sustained by him, thereby giving the lessee a larger share upon production and, consequently, a greater interest in natural deposits in place than he would have had if there had been no cash bonus payment. A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss measured by the difference between cost allocable to the interest sold and the proceeds received.

The stated basic concepts of income and the attending depletion allowances apply to depletion provisions basing allowances on percentages of gross income from the properties as well as to the provisions of the earlier Acts granting allowances based upon cost or value at March 1, 1913, or upon discovery value. In *United States v. Dakota-Montana Oil Co.* [288 *U. S.*, 459, *Ct. D.* 655, C. B. XII-1,243 (1933)] (3 USTC P 1067), treating capitalized intangible costs of development as returnable through the depletion allowance, the Court pointed out that there is "no ground for supposing that Congress by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance." The Court said that the "reasonable inference is that it

did not and that depletion includes under the 1926 Act precisely what it included under the earlier Acts." In *Herring v. Commissioner* [293 *U. X.*, 322, *Ct. D.* 904, C. B. XIV-1,303 (1935)] (35-1 USTC P 9012) the Court stated that the nature and purpose of the allowance based on a percentage of income are the same as in the case of the allowance based on cost, and allowed a lessor receiving an advance royalty or bonus payment upon the execution of an oil and gas lease a percentage depletion allowance thereon. The fact that such an allowance is in anticipation of production was stated to be no more persuasive under the percentage depletion provisions than it was under the depletion provisions of the earlier Acts.

Aside from such bonus payment to a lessor or assignor, the term "gross income," as used in the phrase "gross income from the property" in the percentage depletion provisions, means the same as "gross income" in the provisions generally defining income, with the qualification that the phrase "gross income from the property" in the depletion provisions is confined to the gross income from the extraction of oil rather than gross income from the tract of land in all its uses. [See *Helvering v. Twin Bell Oil Syndicate,* 293 *U. S.*, 312, *Ct. D.* 905, C. B. XIV-1, 253 (1935)] (35-1 USTC P 9014), involving an assignee of an oil and gas lease which was obligated to pay royalties in cash or in kind totaling one-fourth of the oil extracted.) The taxpayer-assignee in *Helvering v. Twin Bell Oil Syndicate supra,* contended that the entire gross income from

production of oil and gas was its gross income from the property and claimed the deduction of 27½ per cent thereof as its allowance for depletion. The Court held that the income from production and sale of the products and the depletion allowance thereon, however measured, must be apportioned between lessor and lessee. Thus the Court confirmed the implications of the earlier cases involving lessors and sublessors or assignors by applying the basic concepts as to (1) gross income from production, and (2) depletion allowances and their division between the respective parties interested.

In the last-cited case the Court, in effect, pointed out that an agreement to pay royalties represents a sharing arrangement between the parties by expressing the view that the provision of a later Act, section 114(b)3, Revenue Act of 1932, which expressly excludes royalties paid or incurred in respect to the property from the lessee's gross income from the property, was merely declaratory of existing law. This implication as to division between the parties by means of royalty payments was confirmed and extended to include divisions effected by agreements to make oil payments in *Thomas v. J. J. Perkins et al.* (301 *U. S.*, 655, *Ct. D.* 1237, C. B. 1937-1, 162) (37-2 USTC P 9315), wherein proceeds from the share of oil reserved by an assignor were held not to be income to the assigne. In that case, lessees of oil and gas leases assigned the leases for $395,000, payable out of one-fourth of the oil produced free of any share of development expense or any other burden. The *Palmer* case, *supra,* was cited as sup-

porting the view that the oil payment interest retained by the assignors gave them ownership of the stipulated share of the oil and entitled them to the income therefrom and the depletion allowance thereon. The *Twin Bell Oil* case, *supra*, was cited as holding that it is immaterial whether the lessor, or sublessor or assignor, is to receive the royalty in oil or the proceeds from the sale of his share of such oil by the lessee.

The cited cases show that the stated basic principles apply equally to mineral deposits and to oil and gas. Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules. The parties entitled to share in oil or mineral extracted or the gross proceeds therefrom (including the parties to a lease providing for royalty payments of stated amounts per unit mined), have economic interests in the oil or minerals in place. That is, they, as owners of the rights in oil or other mineral in place, share the income from production, and the depletion allowances thereon are regarded as designed to permit tax-free recovery of at least their capital investments in such property rights. (See also the *Mountain Producers* case, *supra*, wherein the royalty payable by the producer was measured by a per unit price based on current gasoline prices.)

It will be noted that the persons entitled to oil payments or royalty payments, which the above-cited cases have characterized as the owners of economic interests in oil or mineral in place, by the terms of the agreements from which these rights

arise, are assured of a share if there is production of oil or mineral. *J. Steve Anderson et al. v. Helvering* (310 U. S., 404 Ct. D. 1456, C. B. 1940-1, 108) (40-1 U. S. T. C. P. 9479) confirm this view. The obligation there involved was not an ordinary oil payment right, as it was payable out of proceeds from oil produced or proceeds from resale of the properties. Payment out of proceeds from resale would liquidate the obligation and terminate the right to share in production income.

Assurance of a share upon production marks ownership of an economic interest in oil and gas in place. Division of production income and the attending depletion allowances between owners of economic interests necessarily exclude all others. The right to share in production or gross income therefrom should not be confused with a contractual right to purchase and process a product of the mine or well, even though such processing incidentally aids production and is done under a sharing of the processed product with the producers. In *Helvering v. Bankline Oil Co.* (303 U. S. 362, Ct. D. 1323, C. B. 1938-1, 306) (38-1 U. S. T. C. P. 9154) the taxpayer contracted with producers of oil and gas for the treatment of wet gas to produce gasoline. The taxpayer agreed to install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, and the producers agreed to deliver the natural gas from which the taxpayer was to extract the gasoline and return part of the dry gas to the well to be used therein for pressure purposes. The taxpayer agreed to deliver

one-third of the gasoline extracted or the gross proceeds from the sale of such share. The Court held that the taxpayer was a mere purchaser of the gas produced from the well and not a producer of gas having a depletable economic interest in mineral in place. It should be noted that the taxpayer's capital investment was in equipment facilitating delivery of the gas produced rather than in equipment for production of gas, and that its function was not production of gas, but the processing of gas. The *Mountain Producers* case, *supra,* is distinguishable in that the refining company purchaser therein was a producer and was required to make the capital investments necessary to production that gave the producer an economic interest in oil and gas in place.

Similarly, a right to share in production, or the gross income therefrom, is very different from the right to share in the net income of the producer (a right measured not by production of mineral, as such, but by the degree of success in operation of such a right owned by another). [See *Helvering v. Elbe Oil Land Development Co.,* 303 U. S. 372, Ct. D. 1322, C. B. 1938-1, 293 (38-1 U. S. T. C. P. 9155), as interpreted by the *Anderson* case, *supra,* and *Helvering v. O'Donnell,* 303 U. S. 370, Ct. D. 1324, C. B. 1938-1, 337 (38-1 U. S. T. C. P. 9156).] In the *Elbe* case, *supra,* the rights in oil properties and equipment were transferred for a stated consideration payable in annual installments, irrespective of production from the properties transferred, plus one-third of the net profits derived from operation of the properties by the purchaser after it had been

reimbursed from oil and gas proceeds for all expenditures made by it in the acquisition, development, and operation of the properties. The interest of the seller was thus limited to a right to share in net income after recoupment of capital expenditures rather than gross proceeds from production. In the *O'Donnell* case, *supra,* stock of a corporation owning oil property rights was sold to another corporation (which was to take over in liquidation the oil properties of the first corporation and operate them) for a one-third share of the net profits derived from the operation of the oil properties. In both cases, the Court held the transfers to be sales, and that in neither case did the transferor have a depletable economic interest in the mineral in place after the transaction had been completed.

It seems clear that the right to share in production, or the gross proceeds therefrom, which distinguishes ownership of depletable economic interests in oil or mineral in place from non-depletable economic advantages, including contractual rights to purchase the product or to share in net income, does not depend upon legal title to the oil and gas or mineral deposits. (*Burnet v. Harmel, supra,* and *Palmer v. Bender, supra.*) Also, as noted above, in the *Palmer* case, technical legal description or characterization of the right was treated as immaterial, the Court saying that the owner of a depletable economic interest includes any taxpayer who "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must

look for a return of his capital." In the *Anderson* case, *supra,* the Court, in discussing the *Perkins* case, *supra,* involving an oil payment right reserved upon assignment, said the "decision did not turn upon the particular instrument involved, or upon the practical consequences of the provision for payments of that type."

Such language seems as applicable to grants as to reservations of economic interests, as the formalities of the conveyancer's art are quite as exacting in the reservation of interests as in the grant of interests. If, as the Court indicates, the mere stipulation for oil payments to a person having an investment or capital interest in oil properties amounts, in effect, to a retention of a depletable economic interest in oil in place to the extent of such oil payments, then it would seem to follow that an agreement entitling one making an investment (thereby acquiring a capital interest) in such properties to such payments would give him a corresponding depletable economic interest therein. The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The lessor or assignee, like the lessor or assignor who retained

a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished. Similarly, one who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment allocable to the interest sold). Such a transaction, involving a pledge to use the money furnished in developing the property, is distinguishable from a sale the proceeds of which are uniqualifiedly received by the seller. This view seems to accord with the realities of such transaction. In none of such cases has

the lessee parted with a capital asset, and the investments involved are not his investments.

The stated principles seem applicable irrespective of whether there are words purporting to convey an interest in the oil in place involved in the oil payment rights. Both the practical and economic consequences of provisions for payments of this type are identical in either case. It seems generally agreed that, irrespective of conveyancing formalities, a right to a share of the oil produced carries with it a corresponding interest in the oil in place. That rights to share in the oil produced are analogous to rights to share in gross proceeds derived from the sale of oil produced has been repeatedly stated by the highest court. It would seem to follow that a right to a share of the proceeds from the sale of oil produced would give the payee ownership of a corresponding depletable economic interest without regard to conveyancing formalities.

It thus appears that the controlling cases regard capitalized development costs as representing investments returnable through the depletion allowances, whether the total development investment is made by a landowner who elects to develop the property himself and take all the oil or mineral or is shared by a number of investors who, by contractual arrangements between themselves, agree to divide the resulting oil or mineral product or the proceeds from the sale of such product. If the latter, the division of oil, or the gross income therefrom, determines the economic ownership of oil or mineral in place as well as the gross income and attending de-

pletion allowances. Under this test, the form of the contracts dividing the product or the gross income therefrom, or the legal phraseology or devices utilized to accomplish the division, are immaterial. For example, an instrument purporting to be a "lease" of oil or mineral lands, which gave a "lessee" a right to explore for and produce all the oil or mineral found thereon and required the "lessee" to pay the "lessor" only a share of the net profits derived from the operation (as distinguished from a share of the product or the proceeds from the sale of the product), would leave the "lessor" without a depletable economic interest in the oil or mineral in place, and a "bonus" payment, if any, made upon the execution of such instrument would represent proceeds from the sale of a capital asset. Such results accord with the realities of the test supplied. Under such an agreement, the lessee may exhaust a substantial oil or mineral content with little or no realization of net profits, in which event the lessor will receive little or nothing under the contract. That being true, the lessor in effect has not retained an interest in the oil or mineral content.

Similarly, the Federal income tax status of a "carried interest" depends upon the extent to which such interest in effeect represents a right to share in gross income as distinguished from net income derived from the operation. In *Reynolds v. McMurray* [60 Fed (2d) 843, certiorari denied 287 U. S. 664, *Ct. D.* 616, C. B. XXI-1, 198 (1933)], McMurray was the owner of an undivided interest in oil leases, subject to a contract with the Ohio Oil Co., which

also owned an undivided interest in such leases. Under the contract, the parties agreed that the Ohio Oil Co. was to manage, control, develop, and operate such leases and pay all costs incident thereto, and charge McMurray's undivided interest with its proportionate part thereof; that it should market the oil and gas produced and account to McMurray for his proportionate part thereof; that it should be reimbursed by McMurray from the proceeds derived from the sale of his proportionate part of the oil and gas, to be effected by crediting McMurray's account with the Ohio Oil Co., on the first of each month, with the proceeds derived from the sales during the month preceding of his proportionate part of the oil and gas; and that it should make monthly remittances to him of his proportionate share of any proceeds remaining after deducting the amounts due it for expenditures made by it for him.

The economic or practical effect of such contract was to turn over the leasehold estate to the Ohio Oil Co. for development and the extraction and sale of the product. Though McMurray retained legal title to his undivided interest under the lease, he contracted away the only right granted thereby, *i. e.,* to extract and sell the oil content of the leased land. Thereafter, the development and operation of the property were carried on by the oil company on its own behalf and not as a joint operation by co-owners. Proceeds from the sale of oil were not divided between the parties. Charges and credits in the account between the parties did not reflect actual obligations between them. Rather, they were merely

factors in computing the net income payments which were all McMurray could ever become entitled to under the agrement, regardless of how much oil was extracted and sold from the leased premises. McMurray's interest was converted into a mere contractual right to share in any net income derived from the sale after recoupment of all capital invested by the oil company. The oil company was obligated to make all of the investment necessary to develop the property and to pay all the cost of operation, and it could look only to the proceeds from the sale of the lessee share of oil and gas produced for reimbursement of its capital expenditures and operating expenses. The oil company assumed all the risks and burdens attending development and operation, and it was entitled under the contract to the entire lessee share of production which was the only source from which its capital and expenses could be recouped. Accordingly, such investment was in an economic interest in oil and gas in place measured by the lessee share of production. It is, therefore, the opinion of this office that the decision in that case, holding that the proportionate share of the proceeds from the sale of oil ostensibly credited to McMurray was constructive income to him, is out of harmony with the above-described test of ownership of income from production, and it should no longer be followed. In cases where, after recoupment of such charges or so-called advances to the "carried interest," the interest ceases to be a "carried interest" and the owner thereof becomes entitled to a share in the oil, or the gross income therefrom, and

liable for his share of costs and expenses, he should be regarded as retaining under the contract an economic interest in oil in place, consisting of his undivided interest in the lease less the right of recoupment, which is comparable to an oil payment right, carved out of his fractional working interest.

The questions presented by the supposititious case stated herein are answered generally by the above discussion. Specifically, A, the fee owner, realized $100,000 bonus income when the lease was executed. He also realizes as income one-sixteenth of the proceeds from production until that fraction produces $100,000, and one-eighth of such production as royalty income so long as production continues. All of such income is ordinary income. He is entitled to corresponding depletion allowances, and suffers reductions in the bases of his oil payment and royalty interests reseulting from such depletion deductions. A lessee who subleased or assigned his interest for like consideration would occupy a comparable position. The $200,000 which C paid to B was consideration for the sale of B's interest, less the retained oil payment of one-sixtenth interest until $100,000 is produced. B is not entitled to depletion on the $200,000 cash payment, but he is entitled to depletion on such retained interest. By the "carried interest" arangement between C and D, the former converts a depletable economic interest in oil in place into a non-depletable contractual right to share in D's net income after recoupment by D of all development costs and expenses. Had C received a cash payment, it would have represented proceeds real-

ized upon the sale of a capital asset by him. E, irrespective of words purporting to convey ownership of oil in place, acquired a depletable economic interest to the extent of his oil payment right for a capital investment measured by the expenditure made by him in drilling and equipping the well. F acquired a like interest for the $15,000 furnished by him to D for development purposes. His interest would have been the same had D not been pledged to expend the $15,000 for development. In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss. D, of course, acquired an economic interest consisting of the seven-eighths working interest, less the oil payment rights agreed upon by him or his predecessors and held by A, B, E, and F. His (D's) invested capital account does not include the investment sums contributed by E or F under their contracts with him, but it does include the amount "advanced" by him for C's share of capitalized development cost. (Signed by J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.)"

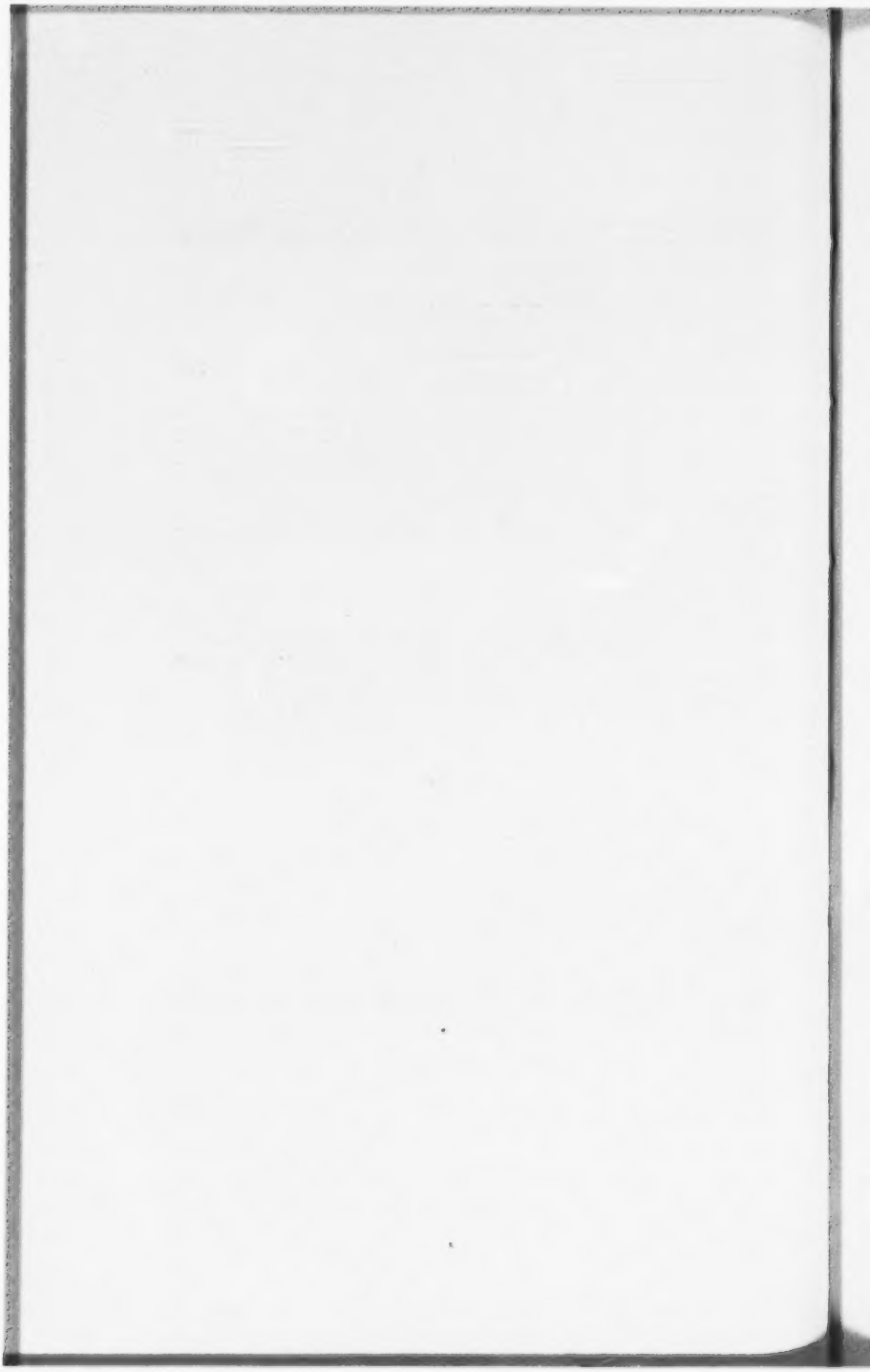
INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Argument	4
Conclusion	5
Appendix	6

CITATIONS

Cases:	
Anderson v. *Helvering*, 310 U. S. 404	4
Palmer v. *Bender*, 287 U. S. 551	4
Statutes:	
Revenue Act of 1928, 45 Stat. 791:	
Sec. 101	6
Sec. 102	7
Sec. 114	7
Revenue Act of 1932, 47 Stat. 169:	
Sec. 101	8
Sec. 102	8
Sec. 114	8
Revenue Act of 1934, 48 Stat. 680:	
Sec. 114 (U. S. C., Title 26, Sec. 114)	8
Sec. 117 (U. S. C., Title 26, Sec. 101)	9

421115—41



In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 624

MARRS MCLEAN, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 179–204) is reported at 41 B. T. A. 565. The opinion of the United States Circuit Court of Appeals (R. 346–352) is reported at 120 F. (2d) 942.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 20, 1941 (R. 352). The petition for a writ of certiorari was filed September 17,

1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the bonus and oil payments which the taxpayer received pursuant to a contract of assignment of certain oil and gas leases, subject to royalties reserved to himself, were, as the Commissioner contends, ordinary income or, as the taxpayer contends, proceeds derived either from the sale or exchange of capital assets, within the meaning of Section 101 of the Revenue Acts of 1928 and 1932 and Section 117 of the Revenue Act of 1934, or from the "sale of mines, oil or gas wells" or of "any interest therein," within the meaning of Section 102 of the Revenue Acts of 1928 and 1932.

STATUTES INVOLVED

These will be found in the Appendix, *infra*, pp. 6–9.

STATEMENT

The facts were stipulated (R. 212–338) and found by the Board as stipulated (R. 182). They may be summarized as follows:

The taxpayer and his wife are residents of Texas and all of their income is community income. They filed separate income-tax returns for each of the taxable years 1930 to 1935, and they kept their books and reported their income during those years upon a cash basis. (R. 182–183.)

In 1919 the taxpayer and his wife leased lands situated in Galveston County, Texas, for the exploration and production of oil, gas, and other minerals. These leases provided for the payment of a one-eighth royalty to the lessors. (R. 183.) Before March 18, 1931, taxpayer and his wife had discovered oil and developed oil production in commercial quantities upon the leased premises. The principal value of the leases was demonstrated by the prospecting, exploration, and discovery work thus done by the taxpayer and his wife. (R. 183, 215.)

On March 18, 1931, taxpayer transferred and assigned the leases to the Yount-Lee Oil Company in consideration of a cash payment of $500,000 and an oil payment of $2,000,000 to be paid out of one-eighth of all oil and gas produced from the lands subject to the leases. In addition, the taxpayer reserved and excepted from the assignment a royalty of twenty-five percent of all the oil produced; it was agreed that the one-eighth base royalty of the landowners was to be paid out of this twenty-five percent royalty. (R. 183–185.)

In their income-tax returns for the years 1931 to 1935, inclusive, the taxpayer and his wife reported the cash and the oil payments made under this contract as proceeds from the sale of capital assets and the royalty payments as ordinary income (R. 186, 223). The Commissioner determined that all the payments constituted ordinary

income and determined deficiencies accordingly (R. 22–31, 74–78, 95–114, 130–139). The Board of Tax Appeals upheld the Commissioner's determination (R. 204–205) and the court below affirmed (R. 352).

ARGUMENT

The transaction here is, as the court below held (R. 350–351), substantially identical with that involved in *Palmer* v. *Bender,* 287 U. S. 551. There, as in this case, the taxpayer assigned an oil and gas lease in return for a cash bonus, an oil payment, and a royalty. This Court held that, because of the retention of the royalty and oil payment interest, the assignment could not be treated as a sale and that, therefore, the taxpayer was entitled to a depletion allowance. That ruling is decisive of the present case. It cannot be distinguished on the ground that it involved the question whether the assignor of the lease was entitled to a depletion allowance rather than whether the assignor realized ordinary income; as this Court pointed out in *Anderson* v. *Helvering,* 310 U. S. 404, 407, "the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable." In view of the recent reaffirmance of the principle of *Palmer* v. *Bender* in the *Anderson* case, there is no occasion for further consideration of the issue in this case.

CONCLUSION

The case was decided by the court below in accordance with the controlling decisions of this Court. There is no conflict. The petition should therefore be denied.

Respectfully submitted.

CHARLES FAHY,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
RICHARD H. DEMUTH,
WARREN F. WATTLES,
Special Assistants to the Attorney General.

OCTOBER 1941.

APPENDIX

Revenue Act of 1928, 45 Stat. 791:

SEC. 101. CAPITAL NET GAINS AND LOSSES.

(a) *Tax in case of capital net gain.*—In the case of any taxpayer, other than a corporation, who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, at the election of the taxpayer, be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½ per centum of the capital net gain.

* * * * *

(c) *Definitions.*—For the purposes of this title—

(1) "Capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.

(2) "Capital loss" means deductible loss resulting from the sale or exchange of capital assets.

(3) "Capital deductions" means such deductions as are allowed by section 23 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year.

* * * * *

(7) "Ordinary net income" means the net income, computed in accordance with the

provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions.

(8) "Capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business. * * *

* * * * *

SEC. 102. SALE OF MINES AND OIL OR GAS WELLS.

(a) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by section 12 of this title attributable to such sale shall not exceed 16 per centum of the selling price of such property or interest.

(b) For limitation to 12½ per centum rate of tax, see section 101.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allow-

ance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Revenue Act of 1932, 47 Stat. 169:

Sections 101 (a) and (c), and 102 are identical, and Section 114 (b) (3) is substantially identical with the corresponding sections of the Revenue Act of 1928, and hence are not repeated here.

Revenue Act of 1934, 48 Stat. 680:

Section 114 (b) (3) is substantially the same as the corresponding section of the two previous Acts.

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or

not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(U. S. C., Title 26, Sec. 101.)

U. S. GOVERNMENT PRINTING OFFICE: 1941

(3)

Office - Supreme Court, U. S.
FILED
NOV 21 1941
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 624

MARIS MCLEAN, *Petitioner,*

v.

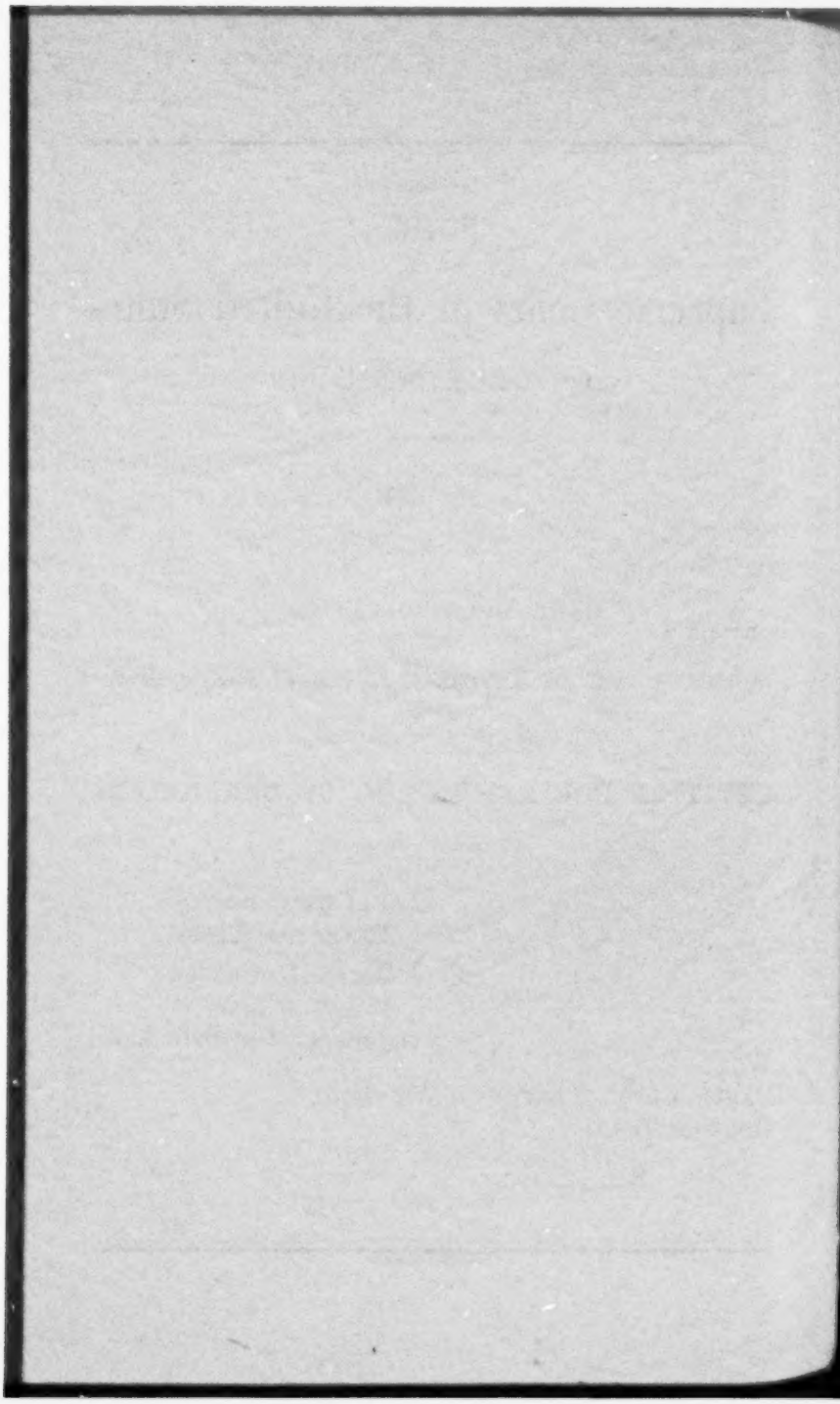
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR REHEARING OF CERTIORARI

L. J. BENCKENSTEIN,
Beaumont, Texas,

PALMER HUTCHESON,
Houston, Texas,
Attorneys for Petitioner.

BAKER, BOTTS, ANDREWS & WHARTON,
Houston, Texas,
Of Counsel.



INDEX

	PAGE
Introduction	1
Questions	2
Grounds—	2
I. Important Questions of Federal Law to Be Settled	2
II. Conflict and Confusion in Federal Court Decisions	23
III. Status of Local and General Law	29
Argument	32
Conclusion	40
Appendix, quoting statutes	42-45

TABLE OF CASES

PAGE

Anderson v. Helvering, 310 U. S. 404, 107 Fed. (2d) 459 ..... 8, 25, 30, 39

Badger Oil Company v. Commissioner, 118 Fed. (2d) 791 24
Berry Oil Company v. United States, 25 Fed. Supp. 97 28
Blankenship v. United States, 95 Fed. (2d) 507 24
Burnet v. Harmel, 287 U. S. 103, 56 Fed. (2d) 153 ..... 3, 14, 20, 25, 36

Columbia Oil & Gas Company v. Commissioner, 118 Fed. (2d) 459 24
Comar Oil Co. v. Burnet, 64 Fed. (2d) 965 29
Commissioner v. Bristol, 121 Fed. (2d) 129 5
Commissioner v. Elbe Oil Land Development Co., 91 Fed. (2d) 127, 303 U. S. 372 ..... 21, 25, 27, 28, 36
Crabb v. Commissioner, 119 Fed. (2d) 772 ..... 24, 27
Cullen v. Commissioner, 118 Fed. (2d) 651 ..... 16, 17, 24, 35, 38

Ferguson v. Commissioner, 45 Fed. (2d) 573 14
Ferguson v. Dickson, 300 Fed. 961 6
Fleming v. Commissioner, 82 Fed. (2d) 324 ..... 16, 17, 24, 26
Fowler v. United States, 11 Fed. (2d) 895 7

Hammonds v. Commissioner, 106 Fed. (2d) 420 ..... 24, 27
Heep Oil Corporation v. United States, 32 Fed. Supp. 762 ..... 24, 28
Helvering v. Bullard, 303 U. S. 297 7
Helvering v. Tex-Penn Oil Co., 28 B. T. A. 917, 300 U. S. 481 ..... 3, 31
Herold v. Commissioner, 42 Fed. (2d) 942 ..... 14, 32

PAGE

Jefferson Gas Coal Company v. Commissioner, 52 Fed. (2d) 120 32

Laird v. Commissioner, 97 Fed. (2d) 730, 91 Fed. (2d) 498 ..... 24, 26, 30

McCaughn, Collector, v. Carter, 19 Fed. (2d) 126 5
McLean v. Commissioner, 120 Fed. (2d) 942 ..... 16, 18, 36
Murphy Oil Company v. Burnet, 287 U. S. 299 3

Palmer v. Bender, 287 U. S. 551, 57 Fed. (2d) 32, 49 Fed. (2d) 316 ..... 3, 8, 9, 10, 11, 12, 14, 19, 20, 21, 22, 23, 24, 25, 32, 33, 34, 37, 38, 39, 40
Pugh v. Commissioner, 49 Fed. (2d) 76 14

Rialto Mining Corp. v. Commissioner, B. T. A. (C. C. H. decision 11262-A) 28
Roeser & Pendleton, Inc., v. Commissioner, 118 Fed. (2d) 462 24

Sheppard, State Comptroller, v. Stanolind Oil & Gas Company, 125 S. W. (2d) 643 29
Sneed v. Commissioner, 119 Fed. (2d) 767 ..... 24, 27
Spalding v. United States, 97 Fed. (2d) 701 24
State v. Quintana Petroleum Company, 133 S. W. (2d) 112 ..... 29, 30

Taft v. Commissioner, 304 U. S. 351 5
Thomas, Collector, v. Perkins, 86 Fed. (2d) 954, 301 U. S. 655 ..... 21, 22, 24, 25, 29, 30, 39

United States of America v. Phellis, 257 U. S. 156 31

Waller v. Commissioner, 40 Fed. (2d) 892, 16 B. T. A. 574 ..... 14, 32

STATUTES, ETC.

	PAGE
General Counsel's Memorandum No. 22730	11, 12, 13, 14
Section 211(b), 1918 Revenue Act (Section 102 of 1928 and 1932 Revenue Acts, and Section 105 of Internal Revenue Code)	3
Section 214(a)(10), 1921 Revenue Act	3
Section 402(c), 1918 Revenue Act [now Section 811(c) of Internal Revenue Code]	4
Texas Statutes, Articles 1291 and 1292	30
Texas Statutes, Article 7146	29, 30
Appendix, quoting Statutes	42-45

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 624

MARRS MCLEAN, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR REHEARING OF CERTIORARI

To The Honorable Chief Justice and
The Associate Justices of the
Supreme Court of the United States:

On October 27th, petition for certiorari was denied in this case, wherein review was sought of the decision of the United States Circuit Court of Appeals for the Fifth Circuit, reported in 120 Fed. (2d) 942. Certiorari was and is the only remedy available to this petitioner, the case being brought before Your Honors under Section 347, Title 28, U. S. C. A., and under Supreme Court Rule 38-5(b). This petition for rehearing is filed under Supreme Court Rule 33.

THE QUESTIONS

The questions involved are whether the fact that an assignor of an oil lease has a right to receive "royalties" and "oil payments," *controls the nature of the transaction,* regardless of the form of the instrument and the intent of the parties, to the extent of depriving the assignor of the benefit, both as to the cash consideration and the "oil payments" involved,(1) not only of the Capital Gains provision, but also (2) of what we term the *"Prospector's Relief"* provision (Sec. 102) of the applicable Revenue Acts, which limits the surtax of an individual who discovers and develops an oil field. The second question will be discussed first as the *primary basis upon which reconsideration is sought* in this petition for rehearing.

THE GROUNDS

There are special and important reasons why this petition for rehearing and the application for certiorari should be granted, as follows:

I.

Important Questions of Federal Law To Be Settled.

When the Honorable Chief Justice was Associate Justice of this Honorable Court in 1932, he wrote the opinions in three cases which were of general importance to the oil industry, because of which fact they were all reviewed by the Court on applications for certiorari. Those cases all appear in Volume 287 of the United States Reports, and are as follows:

Burnet v. Harmel, 287 U. S. 103, which dealt with the Capital Gains provision, only as to an oil *lease,* not a transfer thereof.

Murphy Oil Company v. Burnet, 287 U. S. 299, which dealt with the method of allowing depletion on a bonus received under an oil lease;

Palmer v. Bender, 287 U. S. 551, which dealt with the circumstances under which a transferor of an oil lease would be entitled to invoke what might be termed the Discovery Value Depletion provision [Sec. 214-(a)10, Revenue Act, 1921].

This case involves one entirely different feature of the Income Tax Laws, the provision limiting the *surtax of an individual* who discovers and develops an oil field and later makes a *bona fide* transfer thereof (Sec. 102 of the 1928 and 1932 Acts, designated above as the Prospector's Relief provision). That provision was adopted originally during the World War period at the instance of the National Petroleum War Service Committee as Section 211(b) of the 1918 Act, and is now substantially embraced in Section 105 of the present Internal Revenue Code. It has never been construed or applied by the Supreme Court so far as we can determine, though it was involved in the Board's decision in the case of *Helvering v. Tex-Penn Oil Co.* (28 B. T. A. 917), which was later decided on other points by the Supreme Court (309 U. S. 481). In that case this Honorable Court looked through the form of a transaction which the Commissioner had classified as "indivisible" in order to hold that a tax-free "reorganization" had resulted despite the receipt of cash which the Supreme Court found was consideration to

the stockholders and not to the corporation. In so ruling the Court quoted with approval the following:

> "* * * the rule is well settled that in determining tax liability, taxing authorities must look through form to fact and substance."

In this connection attention is called to the fact that the Prospector's Relief provision (former Section 102) expressly deals with a "*bona fide* sale," thus indicating that the good faith intention of the parties as to the nature and effect of the transaction should control, rather than the mere technical form.

The term "bona fide sale" is, of course, almost identical with the term "bona fide purchaser," and both terms have a well understood meaning under the law. It is universally recognized that those terms are concerned primarily with the *bona fides* of the transaction rather than the exact classification of the transaction from the standpoint of conveyancing. In fact, it is said in 66 *Corpus Juris,* 1095:

> "It is not necessary that a purchaser should claim the fee-simple estate; if he acquires a leasehold estate for value and without notice, he will be protected."

The term "bona fide sale" has been used in other Federal Revenue enactments. In fact, it appeared in the Revenue Act of 1918 (as did the enactment involved herein) under Section 402(c), which is now in substance Section 811 (c) of the Internal Revenue Code. That section deals with the gross estate to be reported under the Estate Tax Law and makes particular provisions with reference to "transfers in contemplation

of or taking effect at death." It provides that the gross estate shall include all such transfers "except in case of a *bona fide sale* * * *." (Italics ours.) The only difference between the original enactment and the enactment as it now appears deals with the language prescribing the nature of the consideration involved, as follows:

> *1918 Act:*
>
> "Bona fide sale for a fair consideration in money or money's worth."
>
> *Internal Revenue Code:*
>
> "Bona fide sale for an adequate or full consideration in money or money's worth."

This change was made only to narrow the broad interpretation of the original requirement as to the *consideration,* but had nothing to do with the character of the transaction from the conveyancing standpoint. *Taft v. Commissioner,* 304 U. S. 351; *Commissioner v. Bristol,* 121 Fed. (2d) 129 (First Circuit). In any event, the Prospectors' Relief provision here involved (Section 102 of the 1928 and 1932 Revenue Acts) is not limited by any designation of the type of consideration to be received by the grantor.

The case of *McCaughn, Collector, v. Carver,* 19 Fed. (2d) 126 (Third Circuit), dealt squarely with the meaning of the term "bona fide sale" as used in Section 402, *supra,* and concluded that it was broad enough to embrace a trust created by a man for his wife in pursuance of an antenuptial agreement. On that point the Court said:

> "At first blush one who *stood on the literalism*

of the statute would say that it was not a sale in the ordinary *mercantile acceptation* of the term. But we find the definition of a sale in Webster is 'the transfer of property * * * from one person to another for a valuable consideration or for a price in money.' * * * Under such circumstances it may reasonably be contended that such a transfer as this *fell within the spirit* and the definition *meaning of the word 'sale.'*

"The substantial element the law considers is not so much the form as *the good faith* and the fair construction of the transaction. Seeing, then, that the law is *fairly open* both to the construction placed upon it by the Commissioner of Internal Revenue, on the one hand, and by the judge below, on the other, and that this uncertainty of construction confronts the application of the law to the state of facts here involved, the general principle that all doubtful constructions must be resolved in favor of the taxpayer would seem to warrant an affirmance of this judgment, if we had—which we do not have—any doubt upon the correctness thereof." (Italics ours.)

A similar conclusion was reached in the case of *Ferguson v. Dickson,* 300 Fed. 961, where the Third Circuit Court, dealing with the same provision of the statute, said (at page 963):

"Many courts have defined a legal sale:

"It is 'a transmutation of property from one man to another in consideration of some price.' 2 Blackstone, 446; Dunn v. Mayo Mills, 134 Fed. 804, 810, 67 C. C. A. 450. 'A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent.' Five Per Cent Cases, 110 U. S. 471, 478, 4 Sup. Ct. 210, 214 (28 L. Ed. 198). 'A sale is a contract by which, for a consideration, one *transfers to an-*

other property or an interest therein.' Yick Sung v. Herman, 2 Cal. App. 633, 83 Pac. 1089, 1091. 'A sale is a contract whereby one acquires a property in the thing sold and the other parts with it for a valuable consideration.' Cole v. Laird, 121 Iowa 146, 96 N. W. 744. *'Every transfer of property for an equivalent is practically and essentially a sale,* and * * * money's worth is a valuable consideration (for the sale) as much as money itself.' Huff v. Hall, 56 Mich. 456, 23 N. W. 88." (Italics ours.)

As late as 1938 this Honorable Court had the same provision of the Act before it in the case of *Helvering v. Bullard,* 303 U. S. 297, and apparently only refused to apply it in that case because the trust therein involved had been declared "void and ineffective" so that the widow "took no interest under it" and therefore could not "spell out a sale."

At the time that the transaction involved in the ininstant case occurred, the Prospector's Relief statute dealt with "a bona fide sale of *mines, oil or gas wells,* or any interest therein," instead of as now "a bona fide sale of ony oil or gas *property,* or any interest therein." The earlier language clearly indicates that the Prospector's Relief provision in its origin was interested primarily in the disposition of the production from the property, and resulting control of the shaft or wells as the case might be, instead of the disposition of the technical title to the property from which the production was derived. This interpretation of the Prospector's Relief provision is reflected in the case of *Fowler v. United States,* 11 Fed. (2d) 895,

wherein the Court, referring to that provision of the law, said:

> "This was for the purpose of stimulating prospecting and exploration, and that the law might be fair to the prospector, who had expended years and money in a fruitless search. * * * If a man who finds is to be deprived of a large part of his profit through large surtaxes, he will prefer to *hold* what he finds."

As indicated it was the "holding" or disposition of the property with which that provision was concerned, rather than the technical features of the title. That is doubtless why the statute prescribed as a feature which would entitle the taxpayer to relief his *bona fides* in transferring the "wells *or any interest therein*" without regard to whether he retained an overriding royalty. In this connection, the Supreme Court in applying the Discovery Value Depletion provision in *Palmer v. Bender* held that there it was not restricted to any "special form of legal interest in the oil well" or to those who are "technically lessors."

In the instant case, it is stipulated that Marrs McLean and wife discovered and developed the oil field, and considered that they were making a "sale or exchange." (Record 215 and 223.) Surely the right to invoke the Capital Gains provision or the Prospector's Relief provision should not be defeated by the fact that the Court put a liberal interpretation on the depletion allowance in the case of *Palmer v. Bender*. The allowance of a depletion deduction is only "an act of grace" (*Anderson v. Helvering*, 310 U. S. 404, at p. 408). It was recognized to be such by

the petitioner in the case of *Palmer v. Bender*, petitioner's brief in support of application for certiorari containing at page 29 the following statement:

> "Since depletion is *purely a grant* from Congress, the sole question here is one of construction of the depletion provisions of the Act and the validity of the Regulations specifically authorized by those provisions for the allowance of the deductions."

Indeed, the petitioner advanced as Point One under his argument there (page 21) the following:

> "Art. 215(a), Regulations 62, as amended, is a reasonable interpretation and application of the depletion provisions of the Revenue Act of 1921, and should not be disturbed."

This leads to a discussion of the effect given to that case in subsequent cases classifying oil transactions as "subleases," subject to depletion, or as "sales," within the meaning of the Capital Gains provision.

The petitioner contended that by every test that could be applied to his transaction, there was no feature or factor that could determine it to be a lease or sublease. It conveyed not just a part of the acreage in the Cade leases, but it conveyed all. It conveyed not just a part of the petitioner's working interest in the Cade leases, but it conveyed all. The transaction not only did not impose any obligations to be performed by the assignee, but specifically protected the assignee against any implied obligations, by the stipulation in (c) of the consideration, "It being expressly understood in this connection that the Yount-Lee Oil

Company shall be under no obligation whatever to the grantor herein to drill upon or develop said land, or any part thereof, for oil." The petitioner also pointed out that the well recognized and accepted feature in leasing and subleasing transactions—that of "reversion" to the grantor—was not provided for in the transaction. The petitioner contended that as to what he assigned he had parted with completely and made delivery of it to the assignee, "Lock, stock and barrel, with no strings attached," and that the transaction could not be otherwise than a sale.

Contrast the petitioner's transaction with that in *Palmer v. Bender,* where there was transferred only a part of a lease, and the transferees were charged with obligations to carry out and perform, for the benefit of the transferors—clearly a subleasing transaction.

The taxpayer intended to make a sale, and sincerely believes that the substance of his transaction confirms that he did, yet the Fifth Circuit Court, on account of the reservations alone, construed his transaction to be a sublease. In doing so, the Fifth Circuit Court was continuing and applying a new rule or doctrine of the law, set up on its own initiative, that reservations determine the nature of transactions.

It would indeed be anomalous if "an act of grace" extended to a taxpayer in *Palmer v. Bender* should create "a rule of thumb" to deprive a taxpayer of other acts of grace such as were intended by the Capital Gains provision and particularly by the Prospector's Relief provision.

It is not believed that the Supreme Court ever in-

tended to substitute for its judgment or the judgment of any other court, in interpreting a contract, any arbitrary rule or factor or test which alone should be determinative of the nature of the transaction, regardless of the language used and the intent of the parties. It is further believed that this Honorable Court, as now composed, has reflected a liberal attitude toward reconsideration, ~~not only of~~ including decisions rendered by the present Court; the latter as instanced by the action of the Court at this term in granting rehearings (including rehearings on applications for certiorari) in certain cases involving civil rights between employers and employees, and rights of parties in criminal prosecutions. While those matters are important they are perhaps no more so than cases involving the oil industry without which there would be few employers and fewer employees.

It is vital to those who develop or deal in the oil industry to know under what conditions they may obtain some relief from taxes that might otherwise make their transactions prohibitive. This was true when in *Palmer v. Bender* this Court construed the Discovery Value Depletion provision. It is equally important today when construction is sought of the Capital Gains provision and particularly the Prospector's Relief provision, which has never been construed by the high court. There has been some effort on the part of the Treasury Department to prescribe some rule to follow generally in oil transactions, but confusion still exists (see recent G. C. M. 22730 captioned):

"(Oil and gas leases: Tax status.) Status of

> oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties."

The General Counsel's Memorandum is set out in full as an appendix to the original petition for *certiorari* filed herein (at page 40). In that Memorandum the General Counsel, speaking of the decision in the case of *Palmer v. Bender,* says:

> "The opinion states that a lessor, or sublessor or *assignor,* who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil in place *entitling him* to depletion deductions against *cash bonus payments* as well as proceeds from his share of the oil." (Italics ours.)

If the Supreme Court in the *Palmer case* held that an *assignor* (as distinguished from a lessor or sublessor) would be *entitled* to depletion on bonus, as well as oil payments or royalty, it certainly did not hold that such an assignor might not instead reserve a royalty and at the same time make a sale of the balance of his interest, which would entitle him to the application of the Capital Gains provision or the Prospector's Relief provision. In other words, the Supreme Court in that case must have, we believe, by applying its rule of looking "through form to fact and substance," concluded that the intention of the

parties was to make a sublease (under the general law, if not the Louisiana law). It would seem hardly fair to say that this conclusion was forced upon the Court by the sole fact that an overriding royalty ran throughout the transaction. Otherwise, there would remain no "freedom of contract," so far as oil transactions are concerned.

The General Counsel's Memorandum also says:

> "A cash payment representing proceeds from the sale of an *economic interest* also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss * * *." (Italics ours.)

If an oil payment is an "economic interest" then its sale like the sale of a royalty would result in a capital gain or loss; yet different effects are sought to be given to the two types of "economic interest" so far as determining the character of a transaction is concerned. For instance the Memorandum continues:

> " cash payment made upon the execution of an instrument stipulating *only for oil payments* is, therefore, regarded not as advance royalty payment but as proceeds from a sale." (Italics ours.)

On the other hand if the factor of royalty is involved, the transaction *ipso facto* is treated as a sublease, and the cash consideration as a bonus subject to depletion. Yet the only possible difference between royalty and "oil payments" is one of possible duration, not one of kind; and even the duration will

be the same where production fails, or else ceases before the "oil payments" are completed.

The quotations from the General Counsel's Memorandum emphasize the importance of having this Honorable Court review the decisions of the lower Federal Courts.

It has been almost ten years since the three cases first cited herein were decided by the Supreme Court, and during that period of time there have been many interpretations and attempted extensions of those cases in decisions by the lower courts, some of which for one reason or another have never reached the high court. The majority of those cases emanated as was to be expected from the Fifth Circuit Court of Appeals, whose decisions in the case of *Burnet v. Harmel,* 56 Fed. (2d) 153, and in *Palmer v. Bender,* 57 Fed. (2d) 32, and the cases originating out of the transaction therein involved [*Waller v. Commissioner,* 40 Fed. (2d) 892 (certiorari denied); *Herold v. Commissioner,* 42 Fed. (2d) 942] and related cases [*Ferguson v. Commissioner,* 45 Fed. (2d) 573, and *Pugh v. Commissioner,* 49 Fed. (2d) 76] had been mainly reversed or overruled. In those decisions the Fifth Circuit Court had given much weight to the rules of law established by the decisions of the State Courts where the oil properties were located, but that Court learned from the decisions of this Honorable Court in *Burnet v. Harmel,* and *Palmer v. Bender,* that when interpreting the Federal Revenue Acts, it should be controlled by the decisions of this Honorable Court without regard to the interpretation of the local law. Since then, it is believed it may be said that the Circuit Court has at-

tempted to adhere rigidly (perhaps too rigidly) to the "rule of thumb" (or to use a more modern term—"yardstick") prescribed.

The statutes and regulations and decisions of the Supreme Court provided for depletion to a lessor on his bonus and reserved "royalties," using the plural and inclusive term. In no instance in the statutes, treasury regulations, nor decisions of the Supreme Court has there been any subdividing of "royalties" (plural and inclusive) into component or singular parts, giving to such component parts a different value or different treatment from that provided for "royalties."

Wholly without support in the statutes, treasury regulations, or decisions of the Supreme Court, the Fifth Circuit Court, by a number of decisions, none of which has been reviewed by the Supreme Court, is setting up a new doctrine in the law of determining the nature of transactions by their reservations, in total disregard of the substance of the transactions.

The Fifth Circuit Court has subdivided "royalties," in its plural and inclusive meaning, into "royalty," and "oil payment," and has given to each an interpretative and determining value, so that in effect that Court is setting up what might be termed "The New Doctrine of Determining Transactions by Their Reservations," to set at naught the intent of the statutes, treasury regulations and the decisions of the Supreme Court.

This new doctrine holds that if the reservations provide for "royalty" (in its singular sense) in the transaction, the transaction is *ipso facto* regarded as a lease

or sublease, regardless of the substance of the transaction. If the transaction provides for a reservation of only an "oil payment," the transaction is *ipso facto* a sale, regardless of its substance.

The petitioner will take the liberty of discussing and quoting from some of the Fifth Circuit Court's decisions, none of which have been reviewed by the Supreme Court, so that this Honorable Court has had no part in the establishment in the law of this new doctrine of determining the nature of transactions by their reservations. If this doctrine is established, which it will seemingly be, if the petitioner's writ is denied, it will result in confusion, uncertainty and doubt, because the application of such doctrine results in definite conflict with the intent of the statutes and decisions of this Court.

The petitioner will briefly quote and discuss the Fifth Circuit Court's decisions in the cases of *Fleming v. Commissioner,* 82 Fed. (2d) 324, *Cullen v. Commissioner,* 118 Fed. (2d) 651, and *McLean v. Commissioner,* 120 Fed. (2d) 942. These decisions will definitely show the erroneous, unjustified and unsound new rule or doctrine of law being set up by the Fifth Circuit Court, that reservations are determinative of the nature of such transactions.

The Fleming Case.

In the Fifth Circuit Court's decision in the case of *Fleming v. Commissioner,* 82 Fed. (2d) 324, the Court said:

"In Palmer v. Bender, however, the transferror

> reserved an additional royalty, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus or advance royalty."

There is nothing in the Palmer decision, directly or by inference, that held that Palmer was a sublessor because of the "royalty" reservation, yet the Fifth Circuit Court makes the declaration above that *because* a "royalty" was reserved, the transaction in *Palmer v. Bender* was found to be a sublease, thus overlooking the fact that the Supreme Court based its decision on the *substance* rather than the form of the transaction. Here, for the first time, a lower court holds that the reservation determines the nature of a transaction. This statement of the Fifth Circuit Court has remained for years unchallenged, because this case and cases following it in the Fifth Circuit Court were not appealed.

The Cullen Case.

The case of *Cullen v. Commissioner* before the Fifth Circuit Court, 118 Fed. (2d) 651, involved the transfer of twelve oil leases to the Humble Company. Nine of the leases reserved an "oil payment" and an excess "royalty." The other three leases provided for a reservation of an "oil payment," but no excess "royalty." All twelve leases were transferred in the same transaction, with the same stipulations, imposing obligations and terms on all leases alike.

The Fifth Circuit Court said in that case:

> "Within the purview of Palmer v. Bender percentage depletion was allowable on all payments

> received as a result of the transfer of those leases in which the taxpayer retained overriding royalty interests. As to the three leases in which no overriding royalty interests were retained percentage depletion should not have been allowed upon the portion of the cash payment attributable to their sale. Commissioner v. Fleming, 82 Fed. (2d) 324, Laird v. Commissioner, 97 Fed. (2d) 730."

The Court here uses the type of reservation to determine the nature of the transaction, holding that the transfer, as to the nine leases reserving "royalty" is to be treated as a sublease with depletion to be allowed on bonus, and reserved interest, but that the transfer as to the three leases reserving only an "oil payment," is to be treated as a sale, with no depletion to be allowed on the cash consideration.

The McLean Case.

The petitioner, in his argument before the Fifth Circuit Court, attacked that court's decision in the *Cullen case,* as to reserved "royalty" being a determinative factor for treating a transaction as a sublease, and the use of an "oil payment" as being a determinative factor for treating a transaction as a sale. The petitioner urged that a reserved "royalty" could not be used as a demarcation point between a sale and a sublease, and that the kind of economic interest reserved was not determinative of anything, and that there was no justification for this ruling in the Statutes, or the decisions of the Supreme Court. The petitioner contended that while his transaction provided for a cash consideration, an oil payment and

a reserved royalty, as did the Palmer transaction, yet the substance of the transactions showed that there was no similarity in their nature and import, and petitioner urged the Court to follow the rule of the Supreme Court to construe transactions on their substance.

The Commissioner answered, as is stated in the Fifth Circuit Court's opinion, as follows:

> "The Commissioner with the rejoinder that 'this is a typical Palmer v. Bender case' would make short shrift of all these arguments and contentions. Invoking Cullen's case in further support, he insists that all else aside, *the reservation of the royalty settles and completely disposes of any question* which might have been in the case if the reservation *had been only of an oil payment.*" (Italics ours.)

There was no argument made by the Commissioner that the *substance* of the petitioner's transaction showed it to be a subleasing transaction, as it was in the *Palmer case,* instead of a sale as contended by the petitioner. The whole basis of comparison used to show that the transaction of the petitioner, and that involved in the *Palmer case,* were similar, or typical of each other, was that both transactions provided for a cash consideration, an oil payment and a reserved royalty.

The contention of the Commissioner was based on the erroneous idea—the new doctrine of determining reservations—that the kind of reservation was the only thing that counted in determining whether the transaction was to be treated as a sublease or a sale. The

Commissioner's contention that the royalty reservation "settles and completely disposes of any question, which might have been in the case * * *" was sustained by the Fifth Circuit Court.

The Fifth Circuit Court in its decision against the petitioner said:

> "Without undertaking any detailed or nice analysis of the language in the instrument upon which the taxpayer relies * * *."

(In this statement, that Court waives aside any necessity for examining the substance of the contract, and shows its lack of concern with its substance) and continues:

> "we think it plain that the transaction as a whole comes strictly within the ruling in the Palmer v. Bender and Burnet v. Harmel cases. Precisely as in Palmer v. Bender, the taxpayer here in the instrument of transfer, reserved in himself an interest in the oil in place. * * * Precisely as in Palmer's case, the taxpayer here retained a right to a share in the oil as produced. * * * Precisely as in that case the taxpayer obtained * * * a part of the fruits of the land as they might be produced, both as to the royalty and as to the payments in oil."

The Fifth Circuit Court definitely bases its decision against the petitioner on the ground that his transaction provided for "precisely" the same reservations as that involved in the *Palmer case* transactions. In so doing that Court says it is strictly within the ruling in the cases of *Palmer v. Bender* and *Burnet v. Harmel.*

There is no ruling in the *Palmer case* that the *reservations* had any more effect than to create, *as to them,* a right to depletion. There is no ruling that the kind of reservations had any interpretative or determinative value as to the nature of the transaction. Nowhere in that decision did the Court rule that a reserved "royalty" was the factor that determined Palmer's right to depletion on his *bonus.* Nowhere in that case did the Court rule that if Palmer had reserved only an "oil payment" interest, his transaction would have been construed as a sale. In no place did the Supreme Court rule that any economic interest differed in value from another.

The petitioner relied on *Thomas v. Perkins* and the *Elbe cases* to support his contention that he was not entitled to depletion on the proceeds from his sale. They were clear, clean-cut decisions, carefully discussed and construed on their *substance,* but the Fifth Circuit Court, in the instant case, after deciding that the similarity of reserved interest brought the transaction strictly within the rulings of the *Palmer v. Bender case,* said:

> "Nothing either in the opinion in the Elbe case, or in its application of its principles to its facts, affords taxpayer any comfort. That opinion reaffirms Palmer v. Bender, *and the result there was reached because there was no reservation of royalty,* there was no retention of ownership, * * *." (Italics ours.)

In this the Fifth Circuit Court declares that the lack of a "royalty" reservation resulted in the Elbe transaction being construed to be a sale.

The fact that there was no "royalty" reserved did not determine one single thing about the transaction being a sale or sublease, and the Supreme Court did not, we understand, hold that the absence of a "royalty" reservation made the transaction a sale.

If the Elbe transaction had been worded throughout, as it was, but had added an exception, so as to reserve a "royalty," there is little doubt that the Supreme Court would still have found it to be a sale as to the cash and profit interest, but would have allowed depletion on the reserved "royalty"; which is a right to share, and an economic interest entitled to depletion such as was held in the *Palmer case* to apply to both a royalty and an oil payment, and such as was held to apply to the reservation of an "oil payment" in the *Perkins case*. In one instance, the *Palmer case*, depletion applied to the reservation in a sublease. In the *Perkins case* it applied to the reservation in a sale.

What would be the situation if a landowner, selling a tract on which no oil was developed, reserved from the sale *all the oil, gas and minerals*, with rights of ingress and egress to develop? Would this be a sale as to what was assigned, or would it be a sublease? Such transactions are universally regarded as sales; so also would a transaction be a sale if an assignor, instead of reserving all of the oil and gas rights, *reserved only a one-eighth royalty.*

Can there be any doubt that this Honorable Court would hold in the case of a sale of the land with either all of the mineral rights reserved, or a royalty interest reserved, that the transaction was a sale as to that part assigned, and that the money received was con-

sideration for that part? Many transactions of this nature are made. What is the difference between the McLean-Yount-Lee transaction and that? McLean was in the position of being the owner, with full vested rights in the fee to the oil and gas. As owner, he made a sale, transferring every interest he had in the working interest and 75 per cent of the oil in these leases. He made his transfer so complete that Yount-Lee became invested with the complete title to the working interest and to 75 per cent of the oil. Should McLean's royalty reservation prevent this transaction from being a sale, when the reservation of the entire mineral rights or of the royalty interest would not have that effect on the transaction if the sale was by a landowner?

If McLean's assignment had been limited and restricted and had provisions for reversion, the situation, of course, would be different. This was not the case. McLean's interest was just as certain as that of the landowner, and his assignment was just as definite and complete, so why should a royalty reservation be treated differently in his transaction than it would be in the event of a sale and reservation by the landowner?

II.

Conflict and Confusion In Federal Court Decisions.

Some of the cases which were decided by the Fifth Circuit Court, after the decision of this Honorable Court in the case of *Palmer v. Bender*, which never reached the High Court, and which involved important

questions pertaining to the oil industry, may be listed as follows:

Fleming v. Commissioner, 82 Fed. (2d) 324.
Blankenship v. United States, 95 Fed. (2d) 507.
Laird v. Commissioner, 97 Fed. (2d) 730 [and 91 Fed. (2d) 498].
Cullen v. Commissioner, 118 Fed. (2d) 651.
Columbia Oil & Gas Company v. Commissioner, 118 Fed. (2d) 459.

Other late decisions from the Fifth Circuit Court are:

Badger Oil Company v. Commissioner, 118 Fed. (2d) 791.
Roeser & Pendleton, Inc., v. Commissioner, 118 Fed. (2d) 462.
Crabb v. Commissioner, 119 Fed. (2d) 772.
Sneed v. Commissioner, 119 Fed. (2d) 767.

A case that was decided by the Fifth Circuit Court, which did reach this Honorable Court, is *Thomas, Collector, v. Perkins,* 86 Fed. (2d) 954 (301 U. S. 655). Cases from other courts of a similar nature, which were never reviewed by the Supreme Court, include *Heep Oil Corporation v. United States,* 32 Fed. Supp. 762 (U. S. Court of Claims); *Hammonds v. Commissioner,* 106 Fed. (2d) 420 (10th Circuit). In *Spalding v. United States,* 97 Fed (2d) 701 (9th Circuit), certiorari was sought but denied.

The Fifth, Ninth and Tenth Circuits involve primarily the states where the production of oil prevails, and this large body of jurisprudence has been built up in these circuits without substantial guidance from the Supreme Court since its decision in *Palmer v. Bender.*

True, the Supreme Court did review from the Ninth Circuit the case of *Commissioner v. Elbe Oil Land Development Company,* 91 Fed. (2d) 127 (303 U. S. 372), and from the Tenth Circuit the case of *Anderson v. Helvering, Commissioner,* 107 Fed. (2d) 459 (310 U. S. 404), in addition to the case of *Thomas, Collector, v. Perkins, supra,* from the Fifth Circuit. However, none of those cases dealt squarely with the question involved in this case or that involved in the case of *Palmer v. Bender,* as to whether the *right of an assignor to receive an oil royalty* converted the assignment from a "sale" into a "sublease"; *particularly* none of them dealt with the *"Prospector's Relief" provision, which, as stated, has never been interpreted or applied by the Supreme Court.*

No hesitancy is felt in saying that the lower courts are now in utter confusion as to what rule of reason or principle should guide them, and that accounts for their adopting a "rule of thumb" or "yardstick" which they assume to have been applied by the Supreme Court to transactions of this nature.

Even if such a new standard or "chemical test," determined by particular factors, is to be applied, for lack of a better guide, petitioner urges that it should not be adopted and applied retroactively to transactions of this nature which like the one here involved occurred even before the decisions in the case of *Burnet v. Harmel, supra,* and *Palmer v. Bender, supra.*

In this connection, it is pointed out that the stipulation in the instant case provides that the transfer "was considered by the petitioners (Marrs McLean

and wife) as the sale or exchange of a capital asset" (Stipulation, paragraph 29, Record 223) and that "the principal value of the leases was demonstrated by prospecting and exploration and discovery work done by Marrs McLean and wife during said period." (Stipulation, paragraph 4, Record 215.) These quotations from the stipulation invoke the application to this transaction of the Capital Gains provision or in the alternative the Prospector's Relief provision.

The unsettled state of the law is further reflected by the following features in decisions of the lower courts:

(a) Judge Hutcheson in the instant case, commenting on the attitude of the Commissioner:

> "Invoking Cullen's case in further support, he insists that all else aside, the reservation of the royalty settles and completely disposes of any question, *which might have been in the case* if the reservation had been only of an oil payment. * * *
>
> "We are not at liberty to repudiate or, at this late date, to *even question* those principles (referring to Palmer v. Bender and Burnet v. Harmel, supra). We think too, that it (the Cullen case) completely disposes against him, of appellant's whole Sec. 101 case, and renders it unnecessary for us to consider what we ought to do with it here if this were a case like Fleming's was, and like Cullen's was in part, of cash and oil payments, *without the reservation of an additional royalty.*" (Italics ours.)

(b) Judge Sibley in the *Fleming case:*

> "In Palmer v. Bender, however, the transferor

reserved an additional royalty, and so was in reality a sublessor, and the cash paid him *could more readily be treated* as a bonus or advance royalty. * * * Section 102 (Prospector's Relief provision), however, makes a special provision 'in the case of a bona fide sale of mines, oil or gas wells, *or any interest therein,*' where the principal value is due to the taxpayer's explorations of the property, limiting the tax to 16 per cent of the selling price. The last-mentioned section is important here as particularly recognizing *sales of interests* in such property as is here involved, and providing for their taxation." (Italics ours except words "or any interest therein.")

(c) Judge Foster's dissent as to the denial of depletion on the cash consideration in the *Fleming case* and his subsequent abandonment of that position and extension of the doctrine in the *Fleming case* to the transaction involved in the case of *Laird v. Commissioner,* 97 Fed. (2d) 730.

(d) Judge Sibley's majority opinion in *Sneed v. Commissioner, supra* (certiorari now pending) and Judge Hutcheson's dessenting opinion in *Crabb v. Commissioner, supra,* dealing with restoration of depletion in the event of non-production.

(e) That portion of Judge Phillips' opinion in *Hammonds v. Commissioner, supra,* under the caption "Was Petitioner Entitled to a Depletion Allowance?".

(f) The three separate opinions of the judges of the Ninth Circuit Court in the case of *Elbe Oil Land Company v. Commissioner,* 91 Fed. (2d) 127, parti-

cularly the language of Judge Wilbur, reading as follows (at page 130):

> "If the case at bar cannot be distinguished from the decision of the Fifth Circuit Court of Appeals in Commissioner v. Fleming, supra, because of the fact that the two $400,000 payments involved here were to be optional with the purchaser, and thus were obviously dependent upon the result of exploratory operations for oil, and because of the fact that the vendee had the right to surrender the premises at any time before the payment of the second $400,000, as the Commissioner contends it can be distinguished, *we must then decline to follow that decision.*"

The opinion of the Supreme Court in the *Elbe case* did not resolve the conflict reflected in the foregoing quotation between the Ninth Circuit and the Fifth Circuit, but decided the case on a different factual basis.

(g) The conflicting opinions of the United States Court of Claims in the cases of *Berry Oil Company v. United States,* 25 Fed. Supp. 97 (certiorari denied) and *Heep Oil Corporation v. United States,* 32 Fed. Supp. 762.

(h) The opinion in the case of *Rialto Mining Corporation v. Commissioner* (C. C. H. Decision 11262-A), wherein the Board of Tax Appeals said:

> "We may leave on one side, however, the question of whether the lessee who has parted with his *full term* by his sublease still retains an estate in the land or merely a chose in action, since if the other factor here involved shall be decided in petitioner's favor it will be sufficient

to dispose of the case. *That factor is the retention of an 'overriding' royalty by the sublessor.*" (Italics ours.)

Despite the fact that in that case the Board recognized that the status of a mining lease was a question of Oklahoma law, it gave controlling effect to the presence of the overriding royalty.

(i) The denial of certiorari by the Supreme Court in the case of *Comar Oil Co. v. Burnet,* 64 Fed. (2d) 965, and that Court's subsequent decision in the case of *Thomas v. Perkins,* wherein emphasis was placed on the division orders as reflecting the interests of the parties. (For division orders in the instant case see Record, page 291 *et seq.*)

III.

Status of Local and General Law.

The local Texas Courts have established as a rule of property and a rule of taxation that royalties and oil payments are equivalent in their legal effect, and the General Law as evidenced by various decisions is to a like effect, particularly as to tax consequences.

The Supreme Court of Texas, in the tax case styled *State v. Quintana Petroleum Company,* 133 S. W. (2d) 112, cited Article 7146 of the Texas Statutes defining "real property for the purpose of taxation," and cited with approval the similar case of *Sheppard, State Controller, v. Stanolind Oil & Gas Company,* 125 S. W. (2d) 643, a decision by the Court of Civil Appeals, in which the Supreme Court had already denied writ of

error. The Court of Civil Appeals at page 648 in the case last cited said of "oil payments" (which it termed "oil bonus"):

> "The oil bonus, as we have seen, partakes in every particular of the nature of royalty and royalty bonus, except only that *its amount is limited.* It is analogous to an overriding royalty. And such it would in fact be if, instead of moving to the lessor, it moved to the lessee under an assignment of the lease."

(Similar in legal effect to Article 7146, mentioned in the *Quintana case, supra,* are Articles 1291 and 1292 of the Texas Statutes, which prescribe the elements of a conveyance in fee simple, all of which appear in this transaction.)

The highest Federal Court in the land has also used similar language in one of its most recent decisions dealing with oil transactions (*Anderson v. Helvering*). In that case this Honorable Court, speaking of the case of *Thomas v. Perkins,* said that the decision established that oil payments "should be given the same *tax consequences* as a provision for oil royalties."

The Fifth Circuit Court in the earlier *Laird case* [*Commissioner v. Laird,* 91 Fed. (2d) 498], speaking of the analogy between the assignor's rights to oil payments and to royalty, said:

> "As to both, he has an economic interest in the oil in place, and as to both, he is entitled to depletion."

However, the Court there held that the analogy could not be pressed to the point contended for by the Commissioner, to the effect that a decedent's estate

should be taxed on royalties and oil payments alike, by valuing both as of the date of death. The Commissioner's contention was summarized as follows by the Court:

> "As to the oil payments, the Commissioner makes his case out by insisting that these payments in reserved minerals until the sum fixed is reached are the same in their *legal incidents and effects* as royalty payments, both being reservations of oil as and when produced, the only difference being that the oil payments are to continue until a definite sum or value is obtained from them, the royalty payments are to continue indefinitely." (Italics ours.)

The fallacy of determining the nature of a transaction by the factor of whether an assignor has the right to receive royalty, or only oil payments, is revealed by the above quotations, thus leading to the conclusion stated by this Honorable Court in *Helvering v. Tex-Penn Oil Company, supra,* as follows:

> "* * * that in determining tax liability, taxing authorities must look through form to fact and substance."

The same rule is stated by this Honorable Court in the case of *United States of America v. Phellis* (257 U. S. 156), as follows:

> "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the 16th Amendment and income tax laws enacted thereunder."

Illustrative of the proper application of the rule thus prescribed by this Honorable Court is the follow-

ing quotation from the case of *Jefferson Gas Coal Company v. Commissioner,* 52 Fed. (2d) 120, at page 122:

> "* * * The real character of an instrument must be determined from the intention of the parties as gathered from a fair interpretation of the instrument as a whole. (Citing authorities.) Looking at the instrument as a whole, and the object sought to be obtained, that there is a *contract of sale of coal in place and not a lease is inescapable."* (Italics ours.)

ARGUMENT

There has probably been no case the issues in which were more litigated or the decision in which has been more discussed and applied and extended by the lower courts than the decision of this Honorable Court in the case of *Palmer v. Bender.* Beginning with the case of *Waller v. Commissioner,* 16 B. T. A. 574, 40 Fed. (2d) 892, in which certiorari was denied by the Supreme Court, and revived in *Herold v. Commissioner,* 42 Fed. (2d) 942 (no certiorari filed), and resumed in *Palmer v. Bender,* 49 Fed. (2d) 316, 57 Fed. (2d) 32, and finally decided in 287 U. S. 551, the case became almost a Magna Charta or Bill of Rights for taxpayers engaged in transactions connected with the oil industry. The case gave a liberal interpretation to a statute that was intended to encourage the discovery and development of oil fields, the importance of the oil industry having been impressed on all at the time of the World War. However, there was another statute designed equally for the same purpose, but made applicable only to individuals who, unlike corporations, were subject

to heavy surtaxes. This was what we have termed the Prospector's Relief Statute, which is here involved.

It is equally important to the oil industry that that Statute be given a liberal application.

Particularly is this true today. All of the current dispatches and comments indicate the importance of developing our oil reserves as rapidly as possible. One of the "O. P. M." officials is quoted as saying:

> "Every war machine that moves these days is powered with a gasoline or oil-burning engine."

Wm. P. Cole, Jr., Maryland Congressman, sometimes rated foremost authority on oil in the Congress of the United States, has just told the American Petroleum Institute at its recent meeting in California: "This is an oil war." He told the oil producers to be ready for a demand of some 5,000,000 barrels per day, about one-fourth more than the present production.

By far the largest oil producing State in the Union is the State of Texas, from which this case emanates. In this instance, however, we find the developer of one of the important Texas oil fields confronted with a serious tax problem which would largely deprive him of the benefit of his discovery and development, merely because his situation, in so far as the issues in this appeal are concerned, demanded the application of the Prospector's Relief provision, or at least the Capital Gains provision, of the law, instead of the Discovery Value Depletion provision that was involved in *Palmer v. Bender*. That this ruling emanated from a misconstruction of the Supreme Court's decision in the case

of *Palmer v. Bender* is reflected by the ruling of the Board on another phase of this appeal (the Gray leases), that was not carried to the Circuit Court. With reference thereto the Board said:

> "The contract covering the Gray leases is different from the contracts covering the other three leases. * * * Although the payments were measured by one-fourth of the net profits realized from the operation of the properties, and although there is no statement in the contract that those payments are to be made from any portion of the oil, nevertheless, this contract did not effect a sale of McLean's interest. It is unlike the contracts in the Elbe and Blankenship cases which purported to convey *all of the interest* of the assignors." (Italics ours.)

Apparently because the contract as to the Gray leases only covered an undivided three-fourths interest instead of McLean's full interest, the Board determined that McLean retained "an economic interest in a part of the oil in place," and that depletion was, therefore, allowable.

As to the phase of the instant case that was carried to the Circuit Court, regardless of what the Court might have ruled as to the other phase that was not presented there, it is plain that the Circuit Court felt obligated to rule that the "reservation of an additional royalty" was the determinative factor under the decision in *Palmer v. Bender*. Referring to that decision the Circuit Court said:

> "We are not at liberty to repudiate or, at this late date, to even question those principles."

And the Court pointed out that this was made the test in the case of *Cullen v. Commissioner, supra,* where it was determined that a part of the transfer was a sale and a part was a sublease, even though all of the leases were assigned as a part of one transaction and by the same instruments which imposed exactly the same obligations as to operation of all of the leases. The Board's opinion in that case said:

> "* * * We cannot agree that the transfer is divisible into a sublease as to all but three of the leases and a sale as to those three. The oral testimony and the documentary evidence refute respondent's argument that this transaction was divisible into separate transfers of one or more leases for varying considerations." (41 B. T. A. 1054.)

On the other hand, the Circuit Court said in the *Cullen case:*

> "We do not agree with the Board's holding that the transfer was not divisible. The facts support the commissioner's determination that the transfer should be broken down into two separate types of transactions."

In other words, in order to give the yardstick of "royalty or no royalty" controlling effect, the Court had to hold that the same parties to the same transaction had two separate intents as to the same general group of properties which were to be operated as a unit—(1) to create a sublease where it happened that a royalty was reserved, and (2) to make a sale where no royalty was reserved; a Doctor Jekyll and Mr. Hyde transaction. Neither side applied for certiorari in the

Cullen case, presumably because the question of allocation might dispose of it, upon the remand to the Board where it is still pending.

We firmly believe that no state rule of property could lead to the anomalous results reflected in the *McLean case* and the *Cullen case* due to the application of the royalty "yardstick." Certainly the Texas statutes do not contemplate that the presence or absence of a provision for royalty would be the controlling factor, in determining the character of title received by an assignee. In fact, Article 1291 provides that regardless of the form, a conveyance of lands (and minerals are a part of the land under the laws of Texas) "shall be deemed a fee simple if a less estate be not limited by *express words* or do not appear to have been granted, conveyed or devised by construction *or operation of law.*" Even an oil lease has been held in Texas to create a "determinable fee." The fact that the fee is determinable under a lease might reconcile the local law with the conclusion reached in *Burnet v. Harmel, supra,* as to such a lease not constituting a sale of a capital asset; but could in no way affect the status as to an assignment of a lease, such as is here involved.

In a day and at the hands of a court where a case like *Erie Railway Company v. Tompkins* could be decided and based not only on legal but constitutional grounds, in order to give effect to state rules of decision, it would seem that there would be more reason to urge also recognition of state rules of property (even when interpreting a Federal Revenue Act), where they do not run contrary to some policy of the

Federal Law. Here the policy of the Federal Law is to encourage and protect the developer of oil property who makes his contracts and conducts his transactions in reliance on the rules of property in the state where the property lies.

The case of *Palmer v. Bender, supra,* which has been relied on by the Circuit Court and the Board of Tax Appeals as the basis for denying the taxpayer relief under either the Capital Gains provisions or the Prospector's Relief provision, was a case where the Supreme Court went out of its way to reverse the judgment of the lower courts in order to extend the taxpayer relief. In other words the Court instead of invoking a technical rule to deny protection to the developer of an oil field applied a liberal rule to afford him protection.

The application for certiorari in that case contains on page 46 the following statement:

> "The trial court found as a fact that it was the intention of the parties to the Smitherman-Ohio transaction to effect a sublease." (Record 49.)"

(No such finding could possibly be made in the instant case in the face of the provision of the *stipulation* heretofore quoted to the effect that the transfer was considered by the petitioners as the sale or exchange of a capital asset.)

Regardless of that finding the Supreme Court in *Palmer v. Bender, supra,* speaking through its present Chief Justice, said:

> "It has been elaborately argued at the bar and

> in the briefs whether under Louisiana law the two instruments are assignments or subleases. We do not think the distinction material."

Interpreting this language the Board of Tax Appeals in the *Cullen case* (41 B. T. A. 1054), said:

> "The Supreme Court held it was immaterial whether the transactions were sales or subleases."

Whether this is a correct interpretation or not, it indicates that the body charged with the interpretation and application of our tax laws understands that the Supreme Court meant to hold that the substance of the transaction must be disregarded in order that the "form" or "rule of thumb" arising from the presence or absence of a right to receive royalty, under an assignment, might always control.

It is hardly believed that the Supreme Court meant by its decision in *Palmer v. Bender* that a transaction could not be a lease or a sale, according to the intent of the parties and the other terms of the instrument, irrespective of whether there existed any right in the grantor to receive either royalties or oil payments. Surely a party can make a lease or a sublease for a period of years in consideration only of the drilling of a well, in which he would have no direct interest but which would benefit the balance of his surrounding property. On the other hand, with equal certainty a party should be able to effectuate a sale of a seven-eighths mineral interest, reserving a one-eighth mineral or royalty interest, with a right of ingress and egress for the purpose of developing

his own interest. Thus, each transaction presents a different case for consideration by the courts.

The case of *Anderson v. Helvering,* 310 U. S. 404, is the latest expression of this Honorable Court pertaining to transactions of this nature. It aptly illustrates, we believe, the fact that this Honorable Court does not intend to extend the rule applied in *Thomas v. Perkins* (301 U. S. 655) to determine the ownership of income derived from oil payments. Obviously if that rule is not to be extended neither can the rule under which depletion was allowed in *Palmer v. Bender* be extended, because as said by this Court in *Anderson v. Helvering:*

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."

While this Court's opinion in the *Anderson case* speaks of giving the factor of the presence of "oil payments" in a transfer "the same tax consequences as a provision for oil royalties," it seems clear that the Court was referring only to the question of allowing depletion on such oil payments, as allowed on oil royalties, and not to the bearing of the presence or absence of either, upon the legal effect of a transfer. Nevertheless, the brief for the respondent (at page 4) in opposition to the petition for certiorari in the instant case, says:

> "In view of the recent affirmance of the principle of Palmer v. Bender, in the Anderson case, there is no occasion for further consideration of the issue in this case."

Conclusion.

In *Palmer v. Bender,* this Honorable Court gave a liberal interpretation to a statute allowing Discovery Value depletion, as an "act of grace." Since no income tax can be laid on anything except the "profit" derived from the disposition of a capital asset, there is more reason to give a liberal interpretation herein, particularly as to a statute that allows a taxpayer to use Discovery Value as a basis of determining the profit, like Section 102 does. Therefore, even if doubt exists, as it certainly does under the confusing decisions of the lower Federal Courts as to the determinative nature of a royalty reservation, that doubt should, we suggest, be resolved in favor of the taxpayer.

Regardless of whether or not this Honorable Court presently thinks that the situation of the petitioner would be changed in a review of his case, it seems to the petitioner that these matters causing confusion, uncertainty and doubt as to the taxpayer's position in sales and subleases should be reviewed and cleared up. This Honorable Court should reaffirm fundamental precepts and doctrines of the law so that they will not be abandoned and yield to the use of erroneous factors. There is no doubt as to the confusion and uncertainty on the part of taxpayers and their attorneys. They see that the Fifth Circuit Court's decisions are turning on a reserved "royalty" interest, or a reserved "oil payment" interest, but they do not see in the statutes or the decisions of the Supreme Court any warrant or justification for the use of reservations as being factors in determining the nature of a transaction.

Even if this Honorable Court should think that a reserved "royalty" should be a controlling factor in determining the nature of such transactions, it would be better to affirm that position by a definite decision, rather than deny this writ of certiorari, for there would still remain doubt and uncertainty in the latter event.

Respectfully submitted,

L. J. BENCKENSTEIN,

PALMER HUTCHESON,
Attorneys for Petitioner,
Marrs LcLean.

I, Palmer Hutcheson, do hereby certify that I am one of the counsel for petitioner herein, and that this Petition for Rehearing is presented in good faith, and not for delay.

PALMER HUTCHESON.

APPENDIX

Section 211(b), 1918 Revenue Act (Section 102 of 1928 and 1932 Revenue Acts, and Section 105 of Internal Revenue Code). From "The Revenue Act of 1932":

> "SEC. 102. SALE OF MINES AND OIL OR GAS WELLS.
>
> "(a) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by Section 12 of this title attributable to such sale shall not exceed 16 per centum of the selling price of such property or interest.
>
> "(b) For limitation to 12½ per centum rate of tax, see Section 101."

Section 214(a)(10), 1921 Revenue Act, provides in part as follows:

> "(a) That in computing net income there shall be allowed as deductions:
>
> "(10) In the case of mines, oil and gas wells, * * * a reasonable allowance for depletion * * * , according to the peculiar conditions in each case * * *: Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: * * * In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

Section 402(c), 1918 Revenue Act [now Section 811(c) of Internal Revenue Code]. From "Internal Revenue Code":

"Sec. 811. Gross estate.

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States—

"(c) Transfers in contemplation of, or taking effect at death. To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this subchapter."

Texas Revised Civil Statutes:

"Art. 1291. When an estate deemed a fee simple.—Every estate in lands which shall thereafter

(hereafter) be granted, conveyed or devised to one although other words heretofore necessary at common law to transfer an estate in fee simple be not added, shall be deemed a fee simple, if a less estate be not limited by express words or do not appear to have been granted, conveyed, or devised by construction or operation of law."

"Art. 1292. Form of conveyance.—The following form, or the same in substance, shall be sufficient as a conveyance of the fee simple of any real estate with a covenant of general warranty, viz.:

" 'The State of Texas,

" 'County of.....

" 'Know all men by these presents, That I, ..., of the.....(give name of city, town or county)....., in the state aforesaid, for and in consideration of.....dollars, to me in hand paid by....., have granted, sold and conveyed, and by these presents do grant, sell and convey, unto the said....., of the .....(give name of city, town or county)....., in the state of....., all that certain .....(describe the premises)..... To have and to hold the above described premises, together with all and singular the rights and appurtenances thereto in anywise belonging, unto the said.....his heirs or assigns forever. And I do hereby bind myself, my heirs, executors and administrators to warrant and forever defend all and singular the said premises unto the said....., his heirs and assigns, against every person whomsoever, lawfully claiming or to claim the same, or any part thereof.

" 'Witness my hand, this.....day of....., A. D. 19.....

" 'Signed and delivered in the presence of .....

" '.....' "

"Art. 7146. 'Real Property.'—Real property for the purpose of taxation, shall be construed to include the land itself, whether laid out in town lots or otherwise, and all buildings, structures and improvements, or other fixtures of whatsoever kind thereon, and all the rights and privileges belonging or in anywise appertaining thereto, and all mines, minerals, quarries and fossils in and under the same."

The Capital Gains provisions of the Federal Revenue Acts are fully set out in the Appendix to the orignal application (page 37) and, therefore, are not repeated here.